

CHAPTER 2

SOLUTIONS TO END OF CHAPTER MATERIAL

QUESTIONS

1. The principal focus of financial accounting is to serve the needs of external decision-makers. These users need financial data about a business to make sound economic decisions. External parties, such as investors, lenders, and other groups (such as the IRS and regulatory bodies) benefit from standardized financial reporting in that information is consistent from year to year and comparable from company to company.

2. The balance sheet equation is $\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$

Assets represent all the items owned by a company. Assets have future economic value in that they can be converted to cash or used to generate revenues. Most assets are tangible and have some type of physical substance. However, some assets such as accounts receivable, patents, and leases have no true physical substance except to be represented by a document.

Liabilities represent all debts owed by a company to other companies or individuals.

All that a company has (assets) minus all it owes (liabilities) is a company's worth, which is known as owners' equity. Equity can come from two sources. It can be contributed by owners; for example, an owner gives \$10,000 of his personal money to the company in exchange for \$10,000 of company equity. Or equity can also be generated by a profitable company.

3. The operating cycle is determined by the time period between the use of cash for normal business operating activities and the receipt or collection of cash from the entity's customers. The operating cycle for a homebuilder could be three to six months, while the operating cycle for winery could be over a year or more. The operating cycle for a service firm could be a matter of days or weeks.

On the balance sheet, assets are classified as current (typically listed first in balance sheet order) if those items will be converted into cash, sold, or used up within the next year or operating cycle, whichever is longer.

4. Retained Earnings does not contain cash. This account is a representation of how the equity in a business has increased because of profitable operations. Each year, the net profit is added to Retained Earnings; profit equals revenues earned minus both the costs

of doing business (expenses) and any distributions to owners (dividends). If there is a net loss, it is deducted from Retained Earnings. Therefore, Retained Earnings is the sum of yearly [revenues – expenses – dividends] since the company began.

5. The income statement is a “period-of-time” statement because the statement will reveal what revenues were earned and expenses incurred during a defined period (e.g., a month or a year). The statement of cash flows and the statement of stockholders’ equity are also “period-of-time” statements. In contrast, the balance sheet is a “point-in-time” statement in that it shows the assets, liabilities, and stockholders’ equity at only one specific moment in time. “Period-of-time” statements allow the user to understand what happened over time, while “point-in-time” statements give information that presents a single moment.
6. Revenues are increases in assets or decreases in liabilities that result from the profit-oriented activities of the business.

Gross profit is the difference between the net revenues generated and the cost of goods sold during a particular period.

Net income is computed by subtracting operating expenses from gross profit and is also known as the “bottom line” of the income statement. Net income is commonly known as profit.

7. Answers will vary based on companies chosen.
8. The common theme of the three financial reporting objectives of business entities is the need for the financial statements to provide external parties the necessary information to make informed decisions about economic events. Without this information, users of financial statements would not be to make appropriate business and investment decisions.
9. Accounting information that is deemed to be reliable has the following three characteristics: verifiability, neutrality, and representational faithfulness. To be verifiable, accounting information should be able to be validated by more than one person. To be neutral, accounting information must be without bias. To be representationally faithful, accounting information must express the business’s true economic resources, obligations, and transactions.
10. The principal reason that historical cost is used as the basis for assets is that it can be verified thorough documentation (bill of sale, etc.). Current values may differ depending on whose opinion is obtained.

The use of historical costs could result in the undervaluation of assets on the balance sheet. Alternatively, liabilities are generally current amounts. This differentiation in valuations causes a net “book value” that borders on meaningless.

11. Revenues should be both realized (assets exchanged for cash or a claim to cash) and earned (provided a product or service) before they are entered in the accounting records of an entity.

There are some instances where the point of sale rule does not apply. For example, many construction projects create economic impacts over multiple years. In such cases, revenues may need to be spread over several accounting periods rather than recorded totally at the end of the project.

12. A general journal contains a chronological listing of transactions and how these transactions affected individual accounts. A general ledger contains individual accounts and shows all the changes made to the account by transactions.

Two separate records are used because events occur that alter two or more accounts simultaneously. A record of the event is found in the general journal. However financial reporting is done on an account basis, so the general journal is used to track changes to individual accounts. A general ledger facilitates for the posting of journal entries into individual accounts and this eases the process of compiling financial statements.

EXERCISES

13. (a) F Intangible assets are not current assets; they will not be used up or converted to cash within one year.
- (b) T Unfortunately, however, management may engage in improper accounting to shift revenues and expenses into inappropriate time periods.
- (c) T
- (d) F Revenues minus expenses is equal to net income. Or revenues minus cost of goods sold is equal to gross profit.
- (e) F This statement describes the full-disclosure principle.
- (f) T
- (g) F Matching refers to the presentation of expenses related to recognized revenues on the income statement.
- (h) T
- (i) F The statement that reconciles beginning and ending cash is the Statement of Cash Flows.
- (j) T
- (k) F Business transactions are recorded in the general journal and then posted to the general ledger.
- (l) F The accounting cycle is not always longer than a company's operating cycle. For example, construction projects and some food products (such as those that must be aged) may have an accounting cycle that is shorter than the operating cycle.

14. (a) $A = L + SE$
 $A = L + \$2,000,000$
 $2X = X + \$2,000,000$
 $X = \$1,000,000 = \text{Liabilities}$
 $A = \$2,000,000$

(b) $SE = \$2,000,000$
 $SE = CS + PIC + RE$
 $\$2,000,000 = \$958,000 + RE$
 $RE = \$1,042,000$

15. Intangible assets	long term asset
Accounts payable	current liability
Inventory	current asset
Cash	current asset
Notes payable (due in ten years)	long term liability
Prepaid expenses	current asset
PPE	long-term asset
Common stock	stockholders' equity
Accounts receivable	current asset
Retained earnings	stockholders' equity
Notes payable (due in six months)	current liability
Additional paid-in capital	stockholders' equity

16. (a) Cash, Short-term investments, Accounts receivable, Inventory, Prepaid expenses

(b) Assets should be listed on the balance sheet in order of liquidity or the ability to turn the assets into cash. The more liquid the asset, the closer to the top of the current asset list it should appear.

17. (a) At the end of the current year, Farewell should report \$90,000 as a long-term liability, and \$30,000 in the current liability section of the balance sheet.

(b) It is important to accurately list the items on the balance sheet so that current and potential creditors and assess the ability of the firm to pay its debts as they come due.

18. (a) Two factors that might contribute to the difference in gross profit for the companies might include the types of shoes that are carried by each wholesaler, the distribution chains that are used by each wholesaler, and the size of the orders placed by each wholesaler's retailing clients. The stores might also have different suppliers of merchandise, which could contribute to a difference in respective cost of goods sold.

(b) As president of Company B, I might investigate the cost of the company's goods (shoes), try to find more reasonable suppliers of merchandise, investigate the

possibility of reducing overhead or distributions costs, and sell in larger quantities to retailers...all of which should lower some costs.

19. Operating items are generated from operating activities (that is, by providing a product or service to a customer). Nonoperating items are generated from investing and financing activities or by events incidental to the operations of a business. These definitions provide the rationale for the items below.

Sales revenue	operating revenue
Cafeteria revenue	nonoperating income
Interest revenue	nonoperating income
Cost of goods sold	operating expense
Utility expense	operating expense
FICA (Social Security) matched amounts	operating expense (part of salaries/wages)
Shipping expense	operating expense (relates to inventory)
Income tax expense	nonoperating expense
Property tax expense	operating expense (assume on property in use in the business, such a manufacturing facility or headquarters)

20. Gross Profit = Revenues – Cost of Goods Sold

Gross Profit = \$750,000 - \$480,000

Gross Profit = \$270,000

Gross Profit Percentage = Gross Profit ÷ Revenues

Gross Profit Percentage = \$270,000 ÷ \$750,000

Gross Profit Percentage = 36%

Oehlke Co. may not have a high enough markup on the product, especially given how high salary costs are in the business. After paying for the product, Oehlke only has 36% of what customers paid for the goods, and Oehlke still has to pay other expenses out of that.

21. (a) relevance
(b) materiality
(c) comparability
(d) understandability
(e) reliability

22. (a) The operating cycle would be 135 days. (90 days + 35 days)

(b) Normally, anything that is receivable or payable within the accounting cycle is classified as current; anything receivable or payable beyond the accounting cycle is classified as long term.

- 23 Several common examples of accrued liabilities at the end of an accounting cycle are salaries owed to employees for work already performed, interest on notes payable, local/state/federal taxes, and utilities.

PROBLEMS

24. (a) Gross Profit = Net Sales – Cost of Goods Sold
 Gross Profit = \$315,000 - \$130,750
 Gross Profit = \$184,250

Operating Income = Gross Profit – SG&A Exp.
 Operating Income = \$184,250 - \$90,050
 Operating Income = \$53,500

Income before Taxes = Operating Income + Interest Revenue
 Income before Taxes = \$53,500 + \$5,000
 Income before Taxes = \$58,500

Net Income = Income before Taxes – Income Tax Expense
 Net Income = \$58,500 - \$2,500
 Net Income = \$56,000

- (b) Valimer Corporation
Income Statement
For *Period Ended Date*

Net Sales	\$315,000
Cost of Goods Sold	<u>(130,750)</u>
Gross Profit	\$184,250
Selling and Administrative Expenses	<u>(90,050)</u>
Operating Income	\$ 94,250
Interest Revenue	<u>5,000</u>
Income Before Income Taxes	\$ 99,250
Income Tax Expense	<u>2,500</u>
Net Income	<u>\$ 96,750</u>

25. (a) $\$35,000 \div 5 \text{ years} = \$7,000 \text{ per year.}$
- (b) $\$7,000 \text{ per year} \times 3 \text{ years} = \$21,000 \text{ of Accumulated Depreciation}$
- (c) The matching principle requires that revenues generated in a particular accounting cycle be matched with the expenses incurred during that same accounting cycle. This purchase reflects an item that should be capitalized and depreciated over the life of the asset rather than expensed immediately on the income statement.

26. (a) $\text{Revenue per unit} = 2 \times \text{cost per unit}$
 $\text{Revenue per unit} = 2 \times \27.50
 $\text{Revenue per unit} = \55.00
- $\text{Sales (2008)} = \text{units sold} \times \text{revenue per unit}$
 $\text{Sales (2008)} = 10,000 \text{ units} \times \55
 $\text{Sales (2008)} = \$550,000$
- (b) $\text{Cost of Goods Sold (CGS)} = \text{units sold} \times \text{cost per unit}$
 $\text{CGS} = 10,000 \times \27.50
 $\text{CGS} = \$275,000$
- $\text{Gross Profit} = \text{Sales (2008)} - \text{CGS}$
 $\text{Gross Profit} = \$550,000 - \$275,000$
 $\text{Gross Profit} = \$275,000$
- (c) $\text{Gross Profit} = \text{Sales} - \text{CGS}$
 $\text{Sales (2009)} = \text{CGS} + \text{Gross Profit}$
 $\text{Sales (2009)} = \$225,000 + \$200,000$
 $\text{Sales (2009)} = \$425,000$
- $\text{Gross Profit \%} = \text{Gross Profit} \div \text{Net Sales}$
 $\text{Gross Profit \%} = \$200,000 \div \$425,000$
 $\text{Gross Profit \%} = 47.1\%$
27. (a) The ending balances on the Statement of Stockholders' Equity for Common Stock, Additional Paid-In Capital, and Retained Earnings are presented on the balance sheet in the Stockholders' Equity section.
- (b) The sale of common stock accounted for an increase in stockholders' equity of \$540,000 (par value of \$240,000 + additional paid-in capital of \$300,000).
28. (a) Green Realty Corp. probably uses this format because the real estate industry's most important asset is its investments. Cash and other types of current assets appear to be almost insignificant amounts to Green Realty.
- (b) Restricted cash would primarily consist of security deposits held on behalf of tenants as well as capital improvement and real estate tax escrows required under certain loan agreements.
- (c) Comparability would not exist within the industry if Green Realty Corp. uses a different format for its balance sheet.

29. (a) Potential investors might want to have prior years' audited financial statements, detailed information about current obligations (both short-term and long-term), and ratio analysis for liquidity. They may also want to see projections for the future, including information about the city/state/country economic health.
- (b) The audited financial statements should help satisfy the following objectives: (1) providing information that is useful in making investing and lending decisions, (2) providing information about assets, liabilities and other transactions that might impact these items, and (3) providing information to allow decision makers to help predict future cash flows.
- (c) The income statement would probably be the most useful for potential investors to examine because it indicates the company's profitability for the period. However, this statement should not be examined without also reviewing the Statement of Cash Flows. Investors would want information about the cash inflows and outflows from operating, investing, and financing activities so as to be able to make judgments about the ability of the firm to meet current obligations as well as determine what type of activities are providing the cash resources that allow the company to meet those obligations.

30. I could not justify inflating sales or net income, even if it meant that possible loss of jobs. Tim should have the accountant project earnings for the next several years with and without the purchase of this piece of equipment. Tim should then take these projections to the bank with him when he goes to see the banker. Tim possibly does not want to appear at fault because of declining profits over the past years.

31. (a and b)

Whitecotton has violated both principles of comparability and consistency with the third change in as many years. These principles make the financial statements more reliable to users, so changing methods of depreciation on a yearly basis might make financial statements unreliable.

Hethcox has followed the principle of full disclosure. Even though the sales happened after the end of the most recent accounting cycle, the operations of these divisions did have an impact on the information being presented currently.

Still Gardening is appropriately applying the lower of cost or market rule (conservatism) for valuing inventory on the balance sheet.

Mason has followed full disclosure of lease payments. This information should be disclosed to financial statement readers and would be of interest to current and potential investors and creditors.

CASES

32. (a) (1) Interest income is separated from is income generated from nonoperating activities like investing and financing activities. Thus, interest income is listed as a separate line item because it is not income generated from the principal activities (providing cruise services) of Carnival.
- (2) Carnival primarily provides a service, although the company does sell some products. For this reason, Carnival's cost of goods sold would be a relatively small portion of its expenses. In fact, the company does not list cost of goods sold separately and does not calculate Gross Profit.
- (3) Primary operating revenues are ticket sales for cruises, sales of sightseeing packages, sales of items to passengers, etc.
- (b) (1) Total Assets = \$34,181,000,000
- (2) A trademark is a symbol or sign used by a business to identify its product or services. Trademarks distinguish a business's services and products and have a considerable intangible value. Trademarks are shown as assets because they have the potential to produce future benefits.
- (3) Cost of PPE \$32,540,000,000
Depreciation \$5,901,000,000
- (4) The historical cost principal dictates that most assets are shown on the financial statements at their original cost. Use of historical cost as the valuation basis for assets stems from the fact that historical cost is more verifiable and less subject to estimation than current values.
- (5) Customer deposits represent money a customer gave Carnival for a future cruise. Until Carnival provides the cruise service to its customer, the money that has been paid by the customer is unearned. Thus, an unearned revenue account is established and this account is classified as current liability because Carnival owes the customer a cruise or a refund.
- (6) The current portion of long-term debt is shown in footnote 5 as \$1,028,000,000. This amount represents the portion of long-term debt that comes due within the next accounting period.
- (7) Profits generated but not distributed to owners are shown in Retained Earnings. As of November 30, 2007, Carnival's Retained Earnings was \$12,921,000,000. During fiscal year 2007, Carnival paid out total dividends of \$990,000,000.
33. (a) For accounting information to be useful, it must possess a high degree of relevance by being timely and having feedback and/or predictive value. The information

contained in Note 7 can help predict amounts that Carnival may owe in the future. Therefore, it is relevant.

- (b) Materiality refers to the relative importance of specific items of accounting information. An item is deemed material if its size (quantitative materiality) or informational content (qualitative materiality) is significant enough to influence a financial statement user's decision. The contingent obligations for Carnival Corporation as of November 30, 2007, amounted to \$1.07 billion. This amount is significant and it could have adverse effects on the financial statements if recognized.
- (c) Objective 1: Financial reports should provide information that is useful in making investing, lending, and other economic decisions.

Objective 2: Financial reports should provide information that is useful to decision-makers in predicting the future cash flows of businesses and future cash dividends from those businesses.

Objective 3: Financial reports should provide information about the assets and liabilities of businesses and the transactions and other events that have resulted in changes in those assets and liabilities.

- (d) Objective 1 would be violated if Note 7 was omitted. Although the amounts described in Note 7 are uncertain, they have the potential to increase expenses or decrease earnings. An investor or lender would want to know this information before making a decision on investment or lending. Also, an investor may not be interested in investing in a company with a potential lawsuit related to The Americans with Disabilities Act.

Objective 2 would also be violated if Note 7 was omitted. Without the information in Note 7, future cash flows might be overestimated.

Objective 3 addresses current and historical numbers. Because the amounts in Note 7 represent the future, Objective 3 would not be violated if Note 7 was omitted.