

Chapter 1

Business: What's It All About?

LEARNING OBJECTIVES

1. Describe what a business does and the various ways a business can be organized.
2. Classify business transactions as operating, investing, or financing activities.
3. Describe who uses accounting information and why accounting information is important to them.
4. Identify the elements of the four basic financial statements—the income statement, the statement of changes in shareholders' equity, the balance sheet, and the statement of cash flows, explain the purpose of each, and be able to use basic transaction analysis to prepare each statement.
5. Identify the elements of a real company's financial statements.
6. Describe the risks associated with being in business and the part that ethics plays in business.

Questions

1. What is the purpose of a business?

Solution:

The purpose of a business is to provide goods and services to customers to make a profit for the owners.

2. Is the goal of all organizations to make a profit?

Solution:

No. Some business organizations, known as not-for-profits, provide goods and services for the sole purpose of helping people. If those organizations do want a profit, they want to use it to provide more goods and services to their clients.

3. Name the three types of activities that make up most business transactions.

Solution:

The three types of activities that make up most business transactions are (1) operating, (2) investing, and (3) financing.

4. What are the possible ownership structures for a business?

Solution:

The possible ownership structures for a business are sole proprietorship, partnership, or corporation.

5. What are the advantages of the corporate form of ownership?

Solution:

The advantages of the corporate form of ownership are limited liability for the owners and the owners can diversify their financial risk.

6. What are the disadvantages of the corporate form of ownership?

Solution:

The disadvantages of the corporate form of ownership are double taxation and lack of owner participation in running the company.

7. Who are some of the people in need of business information and for what purposes?

Solution:

Managers use financial information for internal decision making; investors use financial information to make decisions about investing; creditors use financial information to decide whether to loan money or extend credit. So all of them use the information to make decisions.

8. What is the relationship between the information available to a business and the information provided in financial statements?

Solution:

Financial statement information is only a small part of the information generated and used in a business.

9. What are the basic financial statements? Describe the information that each provides.

Solution:

Income statement: revenues minus expenses for a period of time

Statement of changes in owners' equity: changes in the owners' equity for a period of time

Balance sheet: assets, liabilities, and owners' equity of a business at a specific point in time

Statement of cash flows: all cash inflows and outflows for the period

10. What makes the income statement different from the statement of cash flows?

Solution:

The income statement gives all the revenues earned, whereas the statement of cash flows includes only the cash collected (for current or past revenues). The same is true for expenses. All expenses incurred to generate the period's revenue are included on the period's income statement, whereas only the actual cash outflows are shown on the statement of cash flows.

11. What is XBRL and why is the SEC mandating its use?

Solution:

XBRL is the name for the computer language used to code financial information for submission to the SEC. When all firms use it, their financial information will be easier to use and easier to compare than it is in the current format.

Multiple-Choice Questions

- What type of activities relate to what the firm is in business to do?
 - Investing activities
 - Operating activities**
 - Financing activities
 - Protection activities
- Which financial statement is similar to the accounting equation?
 - The income statement
 - The balance sheet**
 - The statement of changes in shareholders' equity
 - The statement of cash flows
- The Pets Plus Superstore, Inc., acquires 50 doggie beds from a supplier for \$500 in cash. What is the give portion of this transaction?
 - Pets Plus giving the doggie beds to customers in return for cash
 - The supplier giving the doggie beds to Pets Plus
 - Pets Plus giving \$500 in cash to the supplier**
 - The supplier giving \$500 to Pets Plus
- The two parts of shareholders' equity are
 - assets and liabilities.
 - net income and common stock.
 - contributed capital and retained earnings.**
 - revenues and expenses.
- Which financial statement is a snapshot of the financial position of a company at a specific point in time?
 - Income statement
 - Balance sheet**
 - Statement of changes in shareholders' equity
 - Statement of cash flows
- Online Pharmacy Company borrowed \$5,000 cash from the National Bank. As a result of this transaction,
 - assets would decrease by \$5,000.
 - liabilities would increase by \$5,000.**
 - equity would increase by \$5,000.
 - revenue would increase by \$5,000.

7. Accounting information is
 - a. useful in profitable businesses only.
 - b. considered the most important part of a company's information system by all managers.
 - c. an integral part of business.**
 - d. used only by CPAs.
8. During its first year of business, West Company earned service revenues of \$2,000. If the company collected \$700 related to those sales, how much revenue would be shown on West's income statement for the year?
 - a. \$2,000**
 - b. \$700
 - c. \$1,300
 - d. Cannot be determined with the given information
9. Interest is the cost of
 - a. purchasing inventory.
 - b. making a sale.
 - c. being in business.
 - d. using someone else's money.**
10. The balance sheet of United Studios at December 31 showed assets of \$30,000 and shareholders' equity of \$20,000. What were the liabilities at December 31?
 - a. \$30,000
 - b. \$10,000**
 - c. \$20,000
 - d. \$50,000

Short Exercises

Set A

SE1-1A. *Classify business transactions. (LO 2).* For each of the following cash transactions, identify whether it is better described as an operating, financing, or investing activity.

1. An entrepreneur contributes his own money to start a new business.
2. The business buys a machine.
3. The business purchases inventory.
4. The business sells inventory to customers.
5. The business repays a loan.

Solution:

1. financing
2. investing
3. operating
4. operating
5. financing

SE1-2A. *Identify balance sheet items. (LO 4).* Classify the items listed (1 to 6) under the following balance sheet headings:

A - Assets

L - Liabilities

SE - Shareholders' equity

1. _____ Cash
2. _____ Common stock
3. _____ Equipment
4. _____ Notes payable
5. _____ Retained earnings
6. _____ Accounts receivable

Solution:

A - Assets
 L - Liabilities
 SE - Equity

1. A
2. SE
3. A
4. L
5. SE
6. A

SE1-3A. Calculate owners' equity. (LO 4). Doughnut Company shows \$130,000 worth of assets on its December 31, 2009, balance sheet. If the company's total liabilities are \$55,800, what is the amount of owners' equity?

Solution:

$$\begin{array}{rclcl} \text{Assets} & = & \text{Liabilities} & + & \text{Owner's equity} \\ 130,000 & = & 55,800 & + & x \end{array}$$

x = \$ 74,200

SE1-4A. Calculate liability. (LO 4). Given the following items on Tiffany Restoration Company's June 30, 2009, balance sheet, how much did the company owe its creditors on June 30, 2009?

Cash	\$ 1,725	Liabilities	???
Inventory	205		
Equipment	10,636	Common stock	\$7,600
Other assets	8,135	Retained earnings	7,450
Total	<u>\$20,701</u>		

Solution:

$$\begin{array}{rclcl} \text{Assets} & = & \text{Liabilities} & + & \text{Owner's equity} \\ 20,701 & = & x & + & 15,050 \end{array}$$

x = \$ 5,651

SE1-5A. Income statement analysis. (LO 4). For each of the following, calculate the missing amount:

1. Revenues \$560; Expenses \$300; Net Income = _____
2. Net Income \$700; Expenses \$485; Revenues = _____
3. Expenses \$600; Revenues \$940; Net Income = _____
4. Revenues \$1,240; Net Income \$670; Expenses = _____
5. Net Income \$6,450; Expenses \$3,500; Revenues = _____

Solution:

	Revenues	-	Expenses	=	Net income
1.	560	-	300	=	260
2.	1,185	-	485	=	700
3.	940	-	600	=	340
4.	1,240	-	570	=	670
5.	9,950	-	3,500	=	6,450

SE1-6A. Calculate owners' equity. (LO 4). Pasta Enterprises has \$42,000 in cash, \$20,000 in inventory, \$17,000 balance due to creditors, and \$21,000 balance due from customers. What is the amount of owners' equity?

Solution:

Amount of Owners' Equity	
Assets:	
Cash	\$42,000
Accounts receivable	21,000
Inventory	<u>20,000</u>
Total assets	<u>\$83,000</u>
Liabilities: Accounts payable	
	\$17,000
Owners' equity*	<u>66,000</u>
Total liabilities and owners' equity	<u>\$83,000</u>
* 83,000	- 17,000 = <u>66,000</u>

SE1-7A. Calculate retained earnings. (LO 4). Super Shop had a retained earnings balance of \$1,000 on December 31, 2010. For year 2011, sales were \$14,000 and expenses were \$7,500. Cash dividends of \$1,000 were declared and distributed on December 31, 2011. What was the amount of retained earnings on December 31, 2011?

Solution:

Beginning Retained Earnings	\$ 1,000
* + Net income	6,500
- Dividends	<u>(1,000)</u>
= Ending Retained Earnings	<u>\$ 6,500</u>
*Net income = Sales - Expenses	
\$ 6,500 = \$14,000 - \$7,500	

Set B

SE1-8B. Classify business transactions. (LO 2). For each of the following cash transactions, identify whether it is better described as an operating, financing, or investing activity.

1. A firm pays dividends to its shareholders.
2. A firm provides services to its customers.
3. A firm sells inventory.
4. A firm pays its employees for work completed.
5. The business takes out a loan from the local bank.

Solution:

1. financing
2. operating
3. operating
4. operating
5. financing

SE1-9B. *Identify balance sheet items. (LO 4).* Classify the items listed (1 to 6) under the following balance sheet headings:

A - Assets

L - Liabilities

SE - Shareholders' equity

1. _____ Inventory
2. _____ Notes payable
3. _____ Cash
4. _____ Accounts payable
5. _____ Accounts receivable
6. _____ Common stock

Solution:

A - Assets

L - Liabilities

SE - Equity

1. A
2. L
3. A
4. L
5. A
6. SE

SE1-10B. *Calculate owner's equity. (LO 4).* Breck Company shows \$180,000 worth of assets on its December 31, 2011, balance sheet. If the company's total liabilities are \$103,200, what is the amount of owners' equity?

Solution:

Assets	=	Liabilities	+	Owner's equity
180,000	=	103,200	+	x

x =	\$ 76,800
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SE1-11B. *Calculate liability. (LO 4).* Given the following items on Baldwin Company's December 31, 2011, balance sheet, how much did the company owe its creditors on December 31, 2011?

Cash	\$ 2,000	Liabilities	???
Inventory	1,500		
Equipment	10,400	Common stock	\$ 5,000
Other assets	8,100	Retained earnings	12,450
Total	\$22,000		

Solution:

Assets	=	Liabilities	+	Owner's equity
22,000	=	x	+	17,450

x =	\$ 4,550
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SE1-12B. Income statement analysis. (LO 4). For each of the following, calculate the missing amount:

1. Revenues \$860; Expenses \$500; Net Income = _____
2. Net Income \$300; Expenses \$185; Revenues = _____
3. Expenses \$360; Revenues \$1,040; Net Income = _____
4. Revenues \$2,240; Net Income \$1,670; Expenses = _____
5. Net Income \$5,450; Expenses \$1,500; Revenues = _____

Solution:

	Revenues	-	Expenses	=	Net income
1	860	-	500	=	360
2	485	-	185	=	300
3	1,040	-	360	=	680
4	2,240	-	570	=	1,670
5	6,950	-	1,500	=	5,450

SE1-13B. Calculate owners' equity. (LO 4). Lasting Enterprises has \$82,000 in cash, \$30,000 in inventory, \$37,000 balance due to creditors, and \$11,000 balance due from customers. What is the amount of owners' equity?

Solution:

Amount of Owners' Equity			
Assets:			
Cash		\$82,000	
Accounts receivable		11,000	
Inventory		30,000	
Total assets		<u>\$123,000</u>	
Liabilities: Accounts payable		\$37,000	
Owners' equity*		86,000	
Total liabilities and owners' equity		<u>\$123,000</u>	
* 123,000	-	37,000	= <u>86,000</u>

SE1-14B. Calculate retained earnings. (LO 4). M Company had a retained earnings balance of \$4,200 on June 30, 2010. For the fiscal year ended June 30, 2011, sales were \$24,000 and expenses were \$12,500. Cash dividends of \$2,500 were declared and distributed on June 1, 2011. What was the amount of retained earnings on June 30, 2011?

Solution:

Beginning Retained Earnings	\$ 4,200
* + Net income	11,500
- Dividends	(2,500)
= Ending Retained Earnings	<u>\$ 13,200</u>

*Net income	=	Sales	-	Expenses
\$ 11,500	=	\$24,000	-	\$12,500

Exercises

Set A

E1-15A. Business exchanges. (LO 1, 2). Identify the transactions from the following story. For each, identify the transaction as operating, investing, or financing.

Latasha Jones decided to go into business for herself. As a talented Web designer, she decided to open a small consulting firm with \$5,000 of her own money, for which she received common stock. Latasha borrowed \$500 from her best friend to help get the business started, and in exchange she gave her friend an I-owe-you (IOU). The company bought a state-of-the-art desktop computer, complete with the accessories and software needed to get the business off the ground, at a total cost of \$6,000. The business required a separate phone line, which cost \$450. Then, the company put an advertisement in the local newspaper, at a cost of \$45 per month for weekly ads. The company was ready to go. All of the payments were cash.

Solution:

1. Financing
2. Financing
3. Investing
4. Operating
5. Operating

E1-16A. Analyze business transactions using the accounting equation. (LO 4). John Weiss recently started a lawn care service named “The Grass Is Always Greener, Inc.” The following transactions occurred during the company’s first month of business. Enter each of the following transactions into the accounting equation and identify an increase or decrease to assets, liabilities, shareholder’s equity, revenues, or expenses.

1. John contributed \$16,500 of personal savings in exchange for common stock to start the business.
2. The company purchased \$7,500 of inventory (plants and shrubs) from a gardening wholesaler in Kansas.
3. The company purchased three riding lawn mowers at a cost of \$5,000 each.
4. The company paid rent expense of \$500 the first month.
5. The company earned service revenue of \$9,000 and sold the entire \$7,500 of inventory it had purchased to customers for \$13,250 cash.

All the transactions were for cash. Use the following format:

	Total assets	=	Total liabilities	+	Shareholder’s equity	
					Contributed capital	+ Retained earnings
Transaction 1:	_____		_____		_____	_____

Solution:

Total Assets	=	Total Liabilities	+	Shareholder’s equity	
				Contributed Capital	+ Retained Earnings
1. \$16,500 Cash				+ 16,500 Common stock	
2. (7,500) Cash; + 7,500 Inventory					
3. (15,000) Cash; + 15,000 Equipment					
4. (500) Cash					(500) Rent expense
5. + 9,000 Cash					+ 9,000 Revenue
+13,250 Cash					+13,250 Revenue
(7,500) Inventory					(7,500) Cost of goods sold

E1-17A. Classify business transactions. (LO 2). For each of the transactions in E1-16A, tell whether the transaction was an operating, investing, or financing activity.

Solution:

1. financing
2. operating
3. investing
4. operating
5. operating

E1-18A. Analyze the balance sheet. (LO 3, 4). Use the balance sheet for Leatherheads Football Gear, Inc., at August 31, 2010, to answer the following questions:

Leatherheads Football Gear, Inc.
Balance Sheet
At August 31, 2010

Assets		Liabilities and Shareholder's Equity	
Cash	\$ 7,250	Accounts payable	\$ 4,575
Short-term investments	400	Notes payable	11,570
Accounts receivable	275		
Inventory	490	Contributed capital	4,450
Prepaid insurance	345	Retained earnings	3,040
Prepaid rent	875		
Equipment (net)	14,000		
	<u>\$23,635</u>		<u>\$23,635</u>

1. List the assets the company had on August 31, 2010. Who has claim to these assets?
2. List the liabilities the company had on August 31, 2010.

Solution:

1. Assets:

Cash	\$ 7,250
Short-term Investments	400
Accounts receivable	275
Inventory	490
Prepaid insurance	345
Prepaid rent	875
Equipment (net)	14,000

The shareholders have claim to \$7,490 of the assets.

Creditors have claim to \$16,145 of the assets.

2. Liabilities:

Accounts payable	\$ 4,575
Notes payable	11,570

E1-19A. Analyze business transactions using the accounting equation. (LO 4). Enter each transaction below into the accounting equation. Then, calculate (1) the amount of assets owned by Tommy's Irish Pub, Inc., at the end of its first month of business, and (2) the amount of net income for the month. All these transactions took place during the first 30 days of business.

1. Tommy started the pub by contributing \$17,000 in exchange for common stock, and the business borrowed \$12,750 from the bank.
2. The pub purchased \$4,000 worth of beer and other items (its inventory) with cash.
3. The pub hired a bartender to assist Tommy and help run the new company. For this service, the pub paid \$100 each day for 30 days.
4. The pub was popular with the local college and sold half of its inventory for total cash revenues of \$8,500.
5. The pub paid rent expense of \$725 the first month.
6. The pub repaid \$1,500 of the bank loan along with \$50 of interest for the first month.

Solution:

Total Assets		=	Total Liabilities	+	Shareholder's equity	
					Contributed Capital	Retained Earnings
1	+ 29,750 Cash		+ 12,750 Loan payable		+ 17,000 Common stock	
2	(4,000) Cash; + 4,000 Inventory					
3	(3,000) Cash					(3,000) Salary expense
4	+ 8,500 Cash (2,000) Inventory					+ 8,500 Revenue (2,000) Cost of goods sold
5	(725) Cash					(725) Rent expense
6	(1,550) Cash		(1,500) Loan payable			(50) Interest expense
Totals	30,975		11,250		17,000	2,725
Total Assets = 30,975						
Net Income = Revenues - Expenses = 8,500 - 5,775 = 2,725						

E1-20A. *Classify business transactions. (LO 2).* Classify each of the transactions in E1-19A as an operating, investing, or financing activity.

Solution:

- 1 financing
- 2 operating
- 3 operating
- 4 operating
- 5 operating
- 6 financing - principal payment, operating - interest payment

E1-21A. *Business transactions effects on shareholders' equity. (LO 4).* For each of the transactions given, tell whether it increases, decreases, or has no effect on shareholders' equity. Consider both shareholders' equity components—contributed capital and retained earnings.

1. Two friends get together, each contributing \$7,125, to start the Swing Right Golf Supplies Corporation in exchange for common stock.
2. Swing Right purchases equipment for \$6,250 cash.
3. Swing Right purchases \$3,000 worth of inventory for cash.
4. Swing Right pays expenses of \$800 for electricity and phone for the month.
5. Swing Right makes cash sales to customers of \$4,685 during the month.
6. Swing Right pays employees \$2,000 for hours worked during the month.
7. Swing Right declares and pays \$500 dividends to each of its owners at the end of the month.

Solution:

- 1 Increases shareholder's equity - contributed capital
- 2 No effect on shareholder's equity
- 3 No effect on shareholder's equity
- 4 Decreases shareholder's equity - retained earnings
- 5 Increases shareholder's equity - retained earnings
- 6 Decreases shareholder's equity - retained earnings
- 7 Decreases shareholder's equity - retained earnings

E1-22A. Classify cash flows. (LO 2, 4). Classify each transaction as an operating, investing, or financing activity. Assume all transactions are for cash.

1. Jackie Benefield makes a contribution of \$95,000 to start the Horse Trails & Stables from her personal funds in exchange for common stock.
2. The company purchases three horses and some equipment for \$25,000 in cash.
3. The company purchases \$5,000 worth of advertising with the local newspaper.
4. The company pays rent of \$15,000 for barn and pasture space as well as use of 50 acres of land for riding trails.
5. The company hires several people to clean stables at a cost of \$600 for the month.
6. The first customers pay Horse Trails & Stables \$4,225 for six months' worth of riding lessons.

Solution:

- 1 financing
- 2 investing
- 3 operating
- 4 operating
- 5 operating
- 6 operating

E1-23A. Analyze business transactions using the accounting equation. (LO 4). Enter each transaction into the accounting equation and identify its increase or decrease to assets, liabilities, shareholder's equity, revenues, or expenses of Green Trees & Lawn Corp.

1. Green Trees & Lawn earned and collected the cash for \$15,000 in service revenues.
2. The business paid \$2,000 cash for supplies.
3. Green Trees & Lawn paid \$1,500 of a \$4,000 note payable to creditors.
4. The company paid \$1,100 for rent expense.
5. The company's owner provided \$7,500 in additional financing in exchange for common stock.
6. The business declared and paid \$2,100 in dividends.
7. Green Trees & Lawn loaned \$2,225 cash to another company.

Use the following format:

	Total assets	=	Total liabilities	+	Shareholder's equity	
					Contributed capital	Retained earnings
Transaction 1:	_____		_____		_____	_____

Solution:

	Total Assets	=	Total Liabilities	+	Shareholder's equity	
					Contributed Capital	Retained Earnings
1 + 15,000 Cash						+ 15,000 Revenue
2 (2,000) Cash; + 2,000 Supplies						
3 (1,500) Cash			(1,500) Note payable			
4 (1,100) Cash						(1,100) Rent expense
5 + 7,500 Cash					+ 7,500 common stock	
6 (2,100) Cash						(2,100) Dividends
7. (2,225) Cash + 2,225 Loan receivable						

E1-24A. Changes in net income. (LO 4). For each of the following transactions, determine if there is an increase, decrease, or no change on net income for Fun Movie Productions, Inc.

1. Fun Movie earned \$10,000 in monthly sales.
2. The firm recorded a decrease in inventory of \$6,000 due to the monthly sales.
3. The company paid current month's rent of \$1,500.
4. The company paid employees \$2,500 for work done in the current month.
5. The company purchased land for \$7,500.
6. Fun Movie invested \$4,000 in another company's stock.
7. The firm paid \$1,000 in cash dividends.

Solution:

- 1 Increase
- 2 Decrease
- 3 Decrease
- 4 Decrease
- 5 No change
- 6 No change
- 7 No change

E1-25A. Relationship between income statement and balance sheet. (LO 4). Fill in the amounts for X, Y, and Z in the following table. (The company started business on January 1, 2009.)

	December 31, 2009	December 31, 2010
Assets	\$4,550	\$5,225
Liabilities	X	\$1,500
Contributed capital	\$1,300	\$1,300
Retained earnings	Y	Z
Revenue	\$1,250	\$2,575
Expenses	\$ 225	\$1,175

Solution:

	Dec. 31 2009	Dec. 31 2010
Assets	\$ 4,550	\$ 5,225
Liabilities	X	1,500
Contributed capital	1,300	1,300
Retained earnings	Y	Z
Revenue	1,250	2,575
Expenses	225	1,175

First calculate Retained earnings for each year.

$$Y = 1,250 - 225 = 1,025$$

$$Z = (2,575 - 1,175) + 1,025 \text{ (Beg. RE)} = \$2,425$$

Using the accounting equation, calculate X:

$$4,550 = X + 1,300 + Y$$

$$\text{Substitute } Y = 1,025$$

$$X = 4,550 - 1,300 - 1,025$$

$$\mathbf{X = 2,225}$$

E1-26A. Revenues and the statement of cash flows. (LO 4). Bob started a pool cleaning business on the first day of March. He cleaned 15 pools in March and earned \$225 for each cleaning. Most of his customers paid him at the time of cleaning, but one customer, Jeremy Thompson, asked Bob to mail him a bill and he would then send Bob a check. Bob sent Jeremy an invoice but had not yet received the payment by the end of March. When Bob prepares his first monthly income statement, how much will the statement show for revenue for the month ended March 31? How much will be shown on the statement of cash flows as cash collected from customers for the first month?

Solution:

15 pools X \$225 each =	\$ 3,375
Revenue is \$3,375	Income Statement
14 pools paid x 225 =	\$ 3,150
Cash collected = \$3,150	Cash Flows

E1-27A. Expenses and the statement of cash flows. (LO 4). Naida decided to open a candle shop. During her first month of business, she purchased candles from the supplier for a total of \$500 and paid in cash. She sold half of those candles during the month. On the income statement for the month, what amount would appear for the cost of goods sold expense? On the statement of cash flows for the month, what amount would appear as the cash paid to suppliers?

Solution:

\$500 X 1/2 = \$250	
Cost of goods sold expense = \$250	Income Statement
\$500 paid to suppliers	Cash Flows

E1-28A. Retained earnings and cash. (LO 4). Checkmate Games, Inc., started business on April 1, 2011, with \$7,500 cash contribution from its owners in exchange for common stock. The company used \$2,225 of the cash for equipment for the new shop and \$2,750 on games for its inventory. During the month, the company earned \$4,275 of revenue in cash from the sale of the entire inventory. On April 30, 2011, the owners then spent \$3,000 cash on more games for the inventory. What is the retained earnings balance on April 30, 2011? How much cash does the company have on hand on April 30, 2011?

Solution:

Total Assets		=	Total Liabilities	+	Shareholder's equity	
					Contributed Capital	Retained Earnings
1. + 7,500 Cash					+ 7,500 Common stock	
2. (2,225) Cash; + 2,225 Equipment						
3. (2,750) Cash; + 2,750 Inventory						
4. + 4,275 Cash						+ 4,275 Revenue
(2,750) Inventory						(2,750) Cost of goods sold
5. (3,000) Cash; + 3,000 Inventory						
Retained earnings = 4,275 Revenue - 2,750 Cost of goods sold						
	1,525					
Cash balance						
	3,800					

E1-29A. Classify cash flows. (LO 2, 4). For E1-28A, what amounts would Checkmate Games show on its statement of cash flows for the month ended April 30, 2011? Classify each as an operating, investing, or financing cash flow.

Solution:

- | | | |
|-----------------------|----|---------|
| 1. financing | | |
| Issue of common stock | \$ | 7,500 |
| 2. investing | | |
| Purchase of equipment | \$ | (2,225) |
| 3. operating | | |
| Purchase of inventory | \$ | (2,750) |
| 4. operating | | |
| Sales to customers | \$ | 4,275 |
| 5. operating | | |
| Purchase of inventory | \$ | (3,000) |

Set B

E1-30B. Business exchanges. (LO 1, 2). Identify the transactions from the following story. For each, identify the transactions as operating, investing, or financing.

Bonnie Lawhon decided to start a business for herself breeding AKC miniature dachshunds. As a talented breeder who gave puppies to her friends and family, she decided to open a small kennel with \$6,500 of her own money. She received common stock in exchange. The business had concrete poured and fences installed to give the dogs and puppies shelter at a cost of \$3,250, paid in cash. Then, Bonnie's business hired a consultant to design and maintain a Web page for the company at a cost of \$200 for the original design and \$25 per month maintenance. She paid for the design and one month's maintenance fee. The business required a separate mobile phone to be purchased at a cost of \$169 cash. Then, the business put an advertisement in the local newspaper, at a cost of \$20 per month for weekly ads. The business paid cash for one month's advertising. The business was ready to go.

Solution:

1. Financing
2. Investing
3. Operating
4. Operating
5. Operating

E1-31B. Analyze business transactions using the accounting equation. (LO 4). Joe Evans opened a fishing supply store named Evans Bait & Tackle, Inc. The following transactions occurred during its first month. Enter each transaction into the accounting equation and identify an increase or decrease to assets, liabilities, shareholder's equity, revenues, or expenses.

1. Joe Evans used \$100,000 of personal savings in exchange for common stock, and the business borrowed \$50,000 from the bank to start the business.
2. The business purchased a small building for \$75,000.
3. The business purchased \$10,500 worth of inventory.
4. The business paid operating expenses of \$1,315 the first month.
5. Evans Bait & Tackle, Inc., sold \$5,250 of its inventory to customers for \$7,875.

All the transactions were for cash. Use the following format:

			Shareholder's equity			
Total	=	Total	+	Contributed	+	Retained
assets		liabilities		capital		earnings
Transaction 1:	_____	_____	_____	_____	_____	_____

Solution:

<u>Total Assets</u>		=	<u>Total Liabilities</u>	+	<u>Shareholder's equity</u>	
					<u>Contributed Capital</u>	<u>Retained Earnings</u>
1. +150,000 Cash			+ 50,000 Loan payable		+ 100,000 Common stock	
2. (75,000) Cash; + 75,000 Building						
3. (10,500) Cash; + 10,500 Inventory						
4. (1,315) Cash						(1,315) Operating expenses
5. + 7,875 Cash						+ 7,875 Revenue
(5,250) Inventory						(5,250) Cost of goods sold

E1-32B. *Classify business transactions. (LO 2).* For each of the transactions in E1-31B, tell whether the transaction was an operating, investing, or financing activity.

Solution:

1. financing
2. investing
3. operating
4. operating
5. operating

E1-33B. *Analyze the balance sheet. (LO 3, 4).* Use the balance sheet for Specialty Party Supplies, Inc., at December 31, 2011, to answer the following questions:

Specialty Party Supplies, Inc.
Balance Sheet
At December 31, 2011

<u>Assets</u>		<u>Liabilities and Shareholders' Equity</u>	
Cash	\$ 5,000	Accounts payable	\$ 1,770
Short-term investments	300	Notes payable (van)	12,500
Accounts receivable	465		
Inventory	825	Paid-in capital	4,000
Prepaid insurance	500	Retained earnings	4,120
Prepaid rent	300		
Mobile grooming van (net)	15,000		
	<u>\$22,390</u>		<u>\$22,390</u>

1. List the assets the company had on December 31, 2011. Who has claim to these assets?
2. List the liabilities the company had on December 31, 2011.

Solution:

1 Assets:

Cash	\$ 5,000
Short-term Investments	300
Accounts receivable	465
Inventory	825
Prepaid insurance	500
Prepaid rent	300
Mobile grooming van (net)	15,000

The owner has claim to \$8,120 worth of the assets.

The creditors have claim to \$14,270 of the assets.

2 Liabilities:

Accounts payable	\$ 1,770
Notes payable (van)	12,500

E1-34B. Analyze business transactions using the accounting equation. (LO 4). Enter each transaction into the accounting equation. Then, calculate the (1) amount of assets owned by Izzy's Ice Cream Shop at the end of its first month of business and (2) the amount of net income for the month. All transactions took place during the first month; Izzy's was open for 25 days.

1. Izzy started the business by contributing \$5,500 in exchange for common stock, and the firm borrowed \$3,500 from the bank.
2. Izzy's Ice Cream Shop purchased an ice cream delivery truck for \$4,500 cash.
3. The business purchased \$1,200 worth of ice cream and other items (its inventory) for cash.
4. Izzy hired a delivery driver to work two days a week for a total of eight days the first month to help deliver ice cream for the new company. For this service, Izzy's paid \$25 each day worked.
5. The ice cream delivery service was popular and Izzy's sold two-thirds of its inventory for total cash revenues of \$3,600.
6. Izzy's paid operating expenses of \$215 the first month.
7. Izzy's repaid \$100 of the bank loan along with \$5 of interest for the first month.

Solution:

Total Assets		=	Total Liabilities	+	Shareholder's equity	
					Contributed Capital	Retained Earnings
1	+9,000 Cash		+ 3,500 Loan payable		+ 5,500 Common stock	
2	(4,500) Cash; + 4,500 Delivery truck					
3	(1,200) Cash; + 1,200 Inventory					
4	(200) Cash					(200) Salary expense
5	+ 3,600 Cash					+ 3,600 Revenue
	(800) Inventory					(800) Cost of goods sold
6	(215) Cash					(215) operating expenses
7	(105) Cash		(100) loan payable			(5) Interest expense
Totals	11,280		3,400		5,500	2,380

Total Assets = 11,280

Net Income = Revenues - Expenses = 3,600-200-800-215-5 = 2,380

E1-35B. *Classify business transactions. (LO 2).* For each of the transactions in E1-34B, tell whether the transaction was an operating, investing, or financing activity.

Solution:

1. financing
2. investing
3. operating
4. operating
5. operating
6. operating
7. financing - principal payment, operating - interest payment

E1-36B. *Business transactions effects on shareholders' equity. (LO 4).* For each of the transactions given next, tell whether it (1) increases, (2) decreases, or (3) has no effect on shareholders' equity. Consider both shareholders' equity components—contributed capital and retained earnings.

1. Two friends get together, each contributing \$25,000 in cash, to start Luna's Pet Luau in exchange for common stock.
2. Luna's purchases a company van for \$30,000 cash.
3. Luna's buys \$2,250 worth of supplies for cash and uses them all right away.
4. Luna's pays cash expenses of \$2,150 for gas and auto insurance.
5. Luna's earns service revenue from customers of \$8,150 during the month and receives payment in cash.
6. Luna's pays its employees \$465 cash for hours worked during the month.
7. Luna's declares and distributes \$360 cash dividends to each of its owners at the end of the month.

Solution:

1. Increases owner's equity-contributed capital
2. No effect on owner's equity
3. Decreases owner's equity - retained earnings
4. Decreases owner's equity - retained earnings
5. Increases owner's equity - retained earnings
6. Decreases owner's equity - retained earnings
7. Decreases owner's equity - retained earnings

E1-37B. *Classify cash flows. (LO 2, 4).* Classify each cash transaction for the statement of cash flows as an operating, investing, or financing activity.

1. William makes a contribution of \$75,000 from his personal funds to start the Cookie Dough & More Ice Cream Co. and received common stock in exchange.
2. The company purchases a building and some equipment for \$45,000 in cash.
3. The company purchases \$5,500 worth of advertising time on a local television station for cash.
4. The company pays electricity and insurance expenses of \$1,500 for the month.
5. The company hires several people to help make ice cream at a cost of \$350 for the month and pays them in cash.
6. The National Bank pays \$2,500 for ice cream and catering services for its grand opening.

Solution:

1. financing
2. investing
3. operating
4. operating
5. operating
6. operating

E1-38B. *Analyze business transactions using the accounting equation. (LO 4).* Enter each transaction into the accounting equation and identify an increase or decrease to assets, liabilities, shareholders' equity, revenues, or expenses of Captured Memories Photography, Inc.

1. Captured Memories collected and earned \$16,150 in sales revenues.
2. The firm paid \$1,500 cash for supplies.
3. Captured Memories paid \$1,000 of a \$3,000 note payable to creditors.
4. The company paid \$1,750 for operating expenses.
5. The company's owner provided \$6,500 in additional financing in exchange for common stock.
6. The firm declared and paid \$1,020 in dividends.

Use the following format:

				Shareholders' equity			
	Total assets	=	Total liabilities	+	Contributed capital	+	Retained earnings
Transaction 1:	_____		_____		_____		_____

Solution:

	Total Assets	=	Total Liabilities	+	Shareholder's equity	
					Contributed Capital	Retained Earnings
1	+ 16,150 Cash					+ 16,150 Revenue
2	(1,500) Cash; + 1,500 Supplies					
3	(1,000) Cash		(1,000) Note payable			
4	(1,750) Cash					(1,750) operating expenses
5	+ 6,500 Cash				+ 6,500 common stock	
6	(1,020) Cash					(1,020) Dividends

E1-39B. *Changes in net income. (LO 4).* For each of the following transactions, determine if there is an increase, decrease, or no change on net income for Gardenia Lane Productions, Inc.

1. Gardenia Lane earned \$12,000 in monthly sales.
2. The firm recorded a decrease in inventory of \$7,500 due to the monthly sales.
3. Supplies were purchased for \$50, and all of them were used.
4. The company paid employees \$1,715 for current work done.
5. The company purchased land for \$26,500.
6. Gardenia Lane paid rent of \$2,500 for the current month.
7. The firm paid \$1,000 in cash dividends.

Solution:

1. Increase
2. Decrease
3. Decrease
4. Decrease
5. No change
6. Decrease
7. No change

E1-40B. *Relationship between income statement and balance sheet. (LO 4).* Fill in the amounts for X, Y, and Z in the table. The company started business on July 1, 2008.

	June 30, 2009	June 30, 2010
Assets	\$2,000	\$4,250
Liabilities	X	\$2,500
Contributed capital	\$ 500	\$ 700
Retained earnings	Y	Z
Revenue	\$ 800	\$7,200
Expenses	\$ 250	\$6,700

Solution:

	June 30 2009	June 30 2010
Assets	2,000	4,250
Liabilities	X	2,500
Contributed capital	500	700
Retained earnings	Y	Z
Revenue	800	7,200
Expenses	250	6,700

First calculate Retained earnings for each year.

$$Y = 800 - 250 = 550$$

$$Z = 7,200 - 6,700 = 500 + 550 \text{ (beginning RE)} = \$1,050$$

Using the accounting equation, calculate X:

$$2,000 = X + 500 + 550$$

$$X = 950$$

E1-41B. *Revenues and the statement of cash flows. (LO 4).* Frank Frock started a consulting business on the first day of July. He provided consulting services for 30 hours in July and earned \$150 per hour. Most of his clients paid him at the time he provided the services, but one customer, Ray Linch, asked Frank to send him a bill for the 5 hours he worked for him and he would then send the company a check. Frank sent Ray an invoice but had not received his payment by the end of July. When Frank prepares his first monthly income statement, how much will the statement show for revenue for the month? How much will be shown on the statement of cash flows for the month as cash collected from customers?

Solution:

$$\$150 \times 30 \text{ hours} = 4,500$$

Revenue is \$4,500 Income Statement

$$\$150 \times 25 \text{ paid hours} = \$3,750$$

Cash collected = \$3,750 Cash Flows

E1-42B. *Expenses and the statement of cash flows. (LO 4).* Lisa owns a jewelry shop. During her second month of business, she paid \$150 of principal and \$10 of interest on a loan from the bank. On the income statement for the month, what amount would appear as an expense? On the statement of cash flows for the month, what amount would appear as the loan payment to principal? Would each of these activities be classified as operating, financing, or investing?

Solution:

\$10 Interest expense Income Statement
operating activity

\$150 paid on principal Cash Flows
financing activity

E1-43B. Retained earnings and cash. (LO 4). Cookies & Pastries, Inc., started business on July 1, 2010, with a \$16,000 cash contribution from its owners in exchange for common stock. The company used \$7,500 of the cash for equipment for the new shop and \$3,500 for cookies and pastries for its inventory. During the month, the company earned \$7,000 cash revenue from the sale of the entire inventory. On July 31, 2010, the owners spent \$5,000 for more cookies and pastries for the inventory. What is the balance in retained earnings on July 31, 2010? How much cash does the company have on hand on July 31, 2010? Use the accounting equation to help answer the questions.

Solution:

<u>Total Assets</u>		=	<u>Total Liabilities</u>	+	<u>Shareholder's equity</u>	
					<u>Contributed Capital</u>	<u>+ Retained Earnings</u>
1. + 16,000 Cash					+ 16,000 Common stock	
2. (7,500) Cash; + 7,500 Equipment						
3. (3,500) Cash; + 3,500 Inventory						
4. + 7,000 Cash						+ 7,000 Revenue
(3,500) Inventory						(3,500) Cost of goods sold
5. (5,000) Cash; + 5,000 Inventory						
Retained earnings = 7,000 Revenue - 3,500 Cost of goods sold						
3,500						
Cash balance						
7,000						

E1-44B. Classify cash flows. (LO 2, 4). For E1-43B, what amounts would Cookies & Pastries, Inc., show on its statement of cash flows for the month ended July 31, 2010? Classify each as an operating, investing, or financing activity.

Solution:

1. financing	
Cash contributions in exchange for common stock	\$ 16,000
2. investing	
Cash paid for equipment	\$ (7,500)
3. operating	
Cash paid to vendors for inventory	\$ (3,500)
4. operating	
Cash collected from customers	\$ 7,000
5. operating	
Cash paid to vendors for inventory	\$ (5,000)

Problems Set A

P1-45A. *Analyze income statement and balance sheet. (LO 4).* A set of financial statements for Gator Company follows:

Gator Company
Income Statement
For the Year Ended December 31, 2012

Sales	\$600,000
Cost of goods sold	?
Gross profit on sales	375,000
Administrative expenses	54,000
Operating income	?
Interest expense	6,000
Income taxes expense	94,500
Net income	?

Gator Company
Balance Sheet
At December 31, 2012

Cash	\$?	Accounts payable	\$ 13,350
Accounts receivable	13,024	Notes payable	9,830
Inventory	43,271	Contributed capital	605,000
Equipment	972,684	Retained earnings	?
Total	<u>\$1,129,780</u>	Total	<u>?</u>

Requirement

Fill in the missing amounts (indicated with question marks).

Solution:

Income Statement Values

1.	Sales	–	Cost of Goods Sold	=	Gross Profit	
	600,000	–	X	=	375,000	
			X	=	225,000	
2.	Gross Profit on Sales	–	Administrative Expenses	=	Operating Income	
	375,000	–	54,000	=	321,000	
3.	Operating	–	Interest Expense	–	Tax Expense	= Net Income
	321,000	–	6,000	–	94,500	= 220,500

Balance Sheet values:

1. Total liabilities and owners' equity = Total assets
Total liabilities and owners' equity = **\$1,129,780**

2.	Accounts Payable	+	Notes Payable	+	Contributed Capital	+	Retained Earnings		
	13,350	+	9,830	+	605,000	+	X	=	1,129,780
							X	=	501,600

3.	Cash	+	Accounts Receivable	+	Inventory	+	Equipment	=	Total Assets
	X	+	13,024	+	43,271	+	972,684	=	1,129,780
							X	=	100,801

P1-46A. Analyze business transactions using the accounting equation. (LO 3, 4). The following transactions apply to Molly's Maid Service during April 2012:

- Molly started the business by depositing \$5,000 in a business checking account on April 1 in exchange for common stock.
- The company provided services to clients and received \$4,215 in cash.
- The company borrowed \$1,200 from the bank for the business by signing a note.
- The company paid \$1,125 of operating expenses.
- The company purchased a new computer for \$3,000 cash to use to keep track of its customers, starting next month.
- The company declared and distributed \$1,050 to the owner as dividends.

Requirements

- Enter the transactions into the accounting equation.
- What are the total assets of the company at April 30, 2012?
- Prepare a statement of cash flows for the month ended April 30, 2012.
- What was net income for the month ended April 30, 2012?

Solution:

				Shareholders' equity	
1.	Total Assets	=	Total Liabilities	+	Contributed Capital + Retained Earnings
a.	+ 5,000 Cash			+	5,000 Common stock
b.	+ 4,215 Cash				+ 4,215 Revenue
c.	+ 1,200 Cash		+ 1,200 Note payable		
d.	(1,125) Cash				(1,125) Operating expenses
e.	(3,000) Cash; + 3,000 Computer				
f.	(1,050) Cash				(1,050) Dividends
	8,240	=	1,200	+	5,000 + 2,040

2. Total assets = \$8,240

3.

Molly's Maid Service Statement of Cash Flows For the Month Ended April 30, 2012		
Cash from operating activities		
Cash collected from customers	\$4,215	
Cash paid for operating expenses	(1,125)	\$3,090
Cash from investing activities		
Cash paid for computer	(3,000)	(3,000)
Cash from financing activities		
Cash from owner's contributions	5,000	
Cash proceeds from loan	1,200	
Cash dividend paid to owner	(1,050)	5,150
Net increase in cash		<u>\$5,240</u>

4. Revenue - expenses = \$4,215 - \$1,125 = \$3,090

P1-47A. Analyze business transactions and the effect on the financial statements. (LO 2, 4). The following business transactions occurred during Buck's Hunting Gear, Inc.'s first month of business:

- Buck began his business by depositing \$25,000 into the business checking account. He received common stock in exchange.
- The company provided services to customers for \$30,000 cash.
- The company paid travel expenses in the amount of \$1,000 cash.
- The company borrowed \$5,000 from the bank for operating capital.
- The company purchased \$275 worth of office supplies (for future use) from Office Market for cash.
- During the month, the company paid cash of \$5,000 for operating expenses.
- The company paid monthly rent on the retail space in the amount of \$1,250.
- The company paid the staff \$4,200.
- The company declared and paid a dividend of \$1,000 to the owner, John Buck.
- On the last day of the month, Buck's purchased equipment costing \$6,250 by signing a note payable with the bank.

Requirements

For each transaction in items (a)–(j), do the following:

1. Identify whether it is an operating, investing, or financing transaction.
2. Determine whether there is an increase, decrease, or no effect on the total assets of the business.
3. Determine whether there is an increase, decrease, or no effect on net income.
4. Indicate on which financial statement each amount would appear: the income statement (IS), the balance sheet (BS), the statement of changes in shareholder's equity (SE), or the statement of cash flows (CF). (Some will be shown on more than one statement.)

Solution:

Transaction	Operating (O), Investing (I), or Financing (F)	Effect on Assets	Effect on Net Income	Financial Statement
a	F	Increase	No effect	BS, OE, CF
b	O	Increase	Increase	IS, CF*
c	O	Decrease	Decrease	IS, CF*
d	F	Increase	No effect	BS, CF
e	O	No effect	No effect	BS, CF
f	O	Decrease	Decrease	IS, CF*
g	O	Decrease	Decrease	IS, CF*
h	O	Decrease	Decrease	IS, CF*
i	F	Decrease	No effect	OE, CF*
j	I/F notation	Increase	No effect	BS, note on CF

*also affects CASH on the balance sheet

P1-48A. *Analyze business transactions and the effect on the financial statements. (LO 4).* Using transactions a–j in P1-47A, answer the following questions:

Requirements

1. What is the cash balance at the end of Buck's first month of business?
2. Does the company have any liabilities at the end of the first month of business? If so, how much?
3. Which assets will appear on the balance sheet at the end of Buck's first month of business?
4. Did the company generate a net income or a net loss for its first month of business? How much?

Solution:

1 Cash balance:	\$	25,000	contribution
		30,000	service revenue
		(1,000)	travel expense
		5,000	loan
		(275)	supplies
		(5,000)	operating expenses
		(1,250)	rent expense
		(4,200)	salaries expense
		(1,000)	dividends
	\$	<u>47,275</u>	

2 Liabilities	\$	5,000	loan
		6,250	account payable
	\$	<u>11,250</u>	

3 Assets on balance sheet:	
Cash	
Office Supplies	
Equipment	

4 Net income:	
Revenue	\$ 30,000
Expenses	(11,450)
Net income	<u>\$ 18,550</u>

P1-49A. *Analyze effect of transactions on accounting equation. (LO 2, 4).* What will be the effects (increase, decrease, or no effect) on total assets, total liabilities, and total stockholders' equity in each of the following situations? When shareholders' equity changes, note whether it is contributed capital or retained earnings that changes. Identify whether each transaction is an operating, investing, or financing transaction.

	Total assets	=	Total liabilities	+	Shareholders' equity	
					Contributed capital	+ Retained earnings
a. Received cash and issued shares of common stock	_____		_____		_____	_____
b. Purchased equipment with cash	_____		_____		_____	_____
c. Received cash from customers for services rendered	_____		_____		_____	_____
d. Borrowed money from the bank	_____		_____		_____	_____
e. Received a utility bill and paid cash for it	_____		_____		_____	_____

Solution:

	Total Assets	=	Total Liabilities	+	Shareholders' Equity	
					Contributed Capital	+ Retained Earnings
a. Received cash and issued shares of common stock	+				+	
b. Purchased equipment with cash	+ —	(no net effect)				
c. Received cash from customers for services rendered	+					+
d. Borrowed money from the bank.	+		+			
e. Received a utility bill and paid cash for it.	—					—

- a. financing
- b. investing
- c. operating
- d. financing
- e. operating

P1-50A. Analyze business transactions and prepare the financial statements. (LO 4). The following cash transactions took place during July 2010, the first month of business for Stay Bright Cleaning Supplies, Inc.:

- Bill Lunden started a business, Stay Bright Cleaning Supplies, Inc., by contributing \$7,500 cash. He received common stock in exchange.
- The company earned and collected cash revenue of \$2,500.
- The company paid expenses of \$1,250 in cash.
- The company declared and paid dividends of \$500.
- On July 31, the company borrowed \$4,375 from the local bank by signing a three-year note.

Requirements

- Show how each transaction affects the accounting equation.
- Prepare the income statement, statement of changes in shareholder's equity, and statement of cash flows for the month ended July 31, 2010, and the balance sheet at July 31, 2010.

Solution:

1	The Accounting Equation						
	Assets		=	Liabilities	+	Shareholder's Equity	
	Cash	Other				Contributed Capital	+ Retained Earnings
	a.	7,500				7,500 Common stock	
	b.	2,500					2,500 Revenue
	c.	(1,250)					(1,250) Expenses
	d.	(500)					(500) Dividends
	e.	4,375		4,375 Note payable			

2 Stay Bright Cleaning Supplies Inc. Income Statement For the month ended July 31, 2010	
Service revenue	\$ 2,500
Expenses	1,250
Net Income	<u>\$ 1,250</u>

Stay Bright Cleaning Supplies Inc. Balance Sheet At July 31, 2010	
<u>Assets</u>	
Cash	\$ 12,625
Total assets	<u>\$ 12,625</u>
<u>Liabilities & Shareholder's Equity</u>	
Liabilities:	
Long-term notes payable	\$ 4,375
Total liabilities	<u>4,375</u>
Shareholder's Equity:	
Common stock	7,500
Retained earnings	750
Total Liabilities and Equity	<u>\$ 12,625</u>

Stay Bright Cleaning Supplies Inc. Statement of Changes in Shareholder's Equity For the month ended July 31, 2010		
Common stock:		
Beginning balance	\$ -	
Contributions during the month	<u>7,500</u>	
Ending balance		\$ 7,500
Retained Earnings:		
Beginning balance	\$ -	
+ Net income	1,250	
- Dividends	<u>(500)</u>	
Ending balance		750
Total Shareholder's Equity		<u>\$ 8,250</u>

Stay Bright Cleaning Supplies Inc. Statement of Cash Flows For the month ended July 31, 2010		
Cash from operations:		
Cash collected from customers	\$ 2,500	
Cash paid for expenses	<u>(1,250)</u>	
Net Cash from operations		\$ 1,250
Cash from financing activities:		
Issuance of note payable	4,375	
Issuance of common stock	7,500	
Distribution of Dividends	<u>(500)</u>	
Net Cash provided by financing activities:		11,375
Net increase in Cash		12,625
Add beginning cash		-
Cash balance at April 30, 2009		<u>\$12,625</u>

P1-51A. *Retained earnings portion of the statement of changes in shareholders' equity. (LO 4).* The following information is for Rick's Bed and Breakfast:

- Retained earnings on February 1, 2011, were \$150,000.
- In February, revenues were \$35,000 and expenses were \$65,000.
- In March, revenues were \$89,000 and expenses were \$74,000.
- In April, revenues were \$73,000 and expenses were \$62,000.
- The only dividends declared and paid were in April for \$5,000.

Requirements

- Calculate the retained earnings balance for the three months ended April 30, 2011, for Rick's Bed and Breakfast.
- Show the retained earnings portion of the statement of changes in shareholders' equity for the three months ended April 30, 2011.

Solution:

Retained earnings, February 1st, 2011	\$	150,000	Net income for the 3-month period:
Add: Revenues	February	35,000	
	March	89,000	Revenues 197,000
	April	73,000	Expenses (201,000)
Deduct: Expenses	February	(65,000)	Net loss <u>(4,000)</u>
	March	(74,000)	
	April	(62,000)	
Less: Dividends	April	(5,000)	
Retained earnings, April 30th, 2011	\$	<u>141,000</u>	

Rick's Bed & Breakfast
Statement of Retained Earnings
For the Quarter Ended April 30th, 2011

Retained earnings, February 1st, 2011	\$	150,000
Deduct Net loss		(4,000)
Less: Dividends		(5,000)
Retained earnings, April 30th, 2011	\$	<u>141,000</u>

Set B

P1-52B. *Analyze income statement and balance sheet. (LO 4).* A set of financial statements for Shelby's Music, Inc., follows:

Shelby's Music, Inc.
Income Statement
For the Year Ended June 30, 2012

Sales	?
Cost of goods sold	<u>375,000</u>
Gross profit on sales	525,000
Administrative expenses	<u>?</u>
Operating income	419,000
Interest expense	<u>?</u>
Income taxes	142,450
Net income	<u>\$264,550</u>

Shelby's Music, Inc.
Balance Sheet
At June 30, 2012

Cash	\$158,592	Accounts payable	\$ 14,070
Accounts receivable	18,621	Notes payable	12,520
Inventory	?		
Equipment	895,895	Contributed capital	?
		Retained earnings	425,000
Total	<u>?</u>	Total	<u>\$1,231,000</u>

Requirements

Fill in the missing amounts (indicated with question marks).

Solution:

Income Statement Values

1.	Sales	—	Cost of Goods Sold	=	Gross Profit		
	X	—	375,000	=	525,000		
			X	=	900,000		
2.	Gross Profit	—	Administrative	=	Operating		
	on Sales		Expenses		Income		
	525,000	—	X	=	419,000		
			X	=	106,000		
3.	Operating	—	Interest Expense	—	Tax Expense	=	Net Income
	419,000	—	X	—	142,450	=	264,550
			X	=	12,000		

Balance Sheet values:

1. Total liabilities and owners' equity = Total assets
Total assets = **\$1,231,000**

2.	Cash	+	Accounts Receivable	+	Inventory	+	Equipment	=	Total Assets
	\$158,592	+	\$18,621	+	X	+	\$895,895	=	\$1,231,000
							X	=	\$157,892
3.	Accounts Payable	+	Notes Payable	+	Contributed Capital	+	Retained Earnings		
	\$14,070	+	\$12,520	+	X	+	\$425,000	=	\$1,231,000
							X	=	\$779,410

P1-53B. Analyze business transactions using the accounting equation. (LO 3, 4). The following transactions apply to Bostic's Auto Detail Service during November 2012:

- Xavier Bostic started the business by depositing \$3,350 in a business checking account on November 1 in exchange for common stock.
- The company purchased a vacuum cleaner for \$1,145 cash.
- The company borrowed \$1,575 from the bank for the business by signing a note.
- The company provided services to clients and received \$5,705 in cash.
- The company paid \$535 of operating expenses.
- The company declared and made a distribution of \$200 to the owner.

P1-54B. *Analyze business transactions and the effect on the financial statements. (LO 2, 4).* The following business transactions occurred during Heidi's Smoothy Shop, Inc.'s first month of business:

- Heidi began her business by depositing \$22,000 into the business checking account in exchange for common stock.
- The shop paid travel expenses in the amount of \$325.
- The shop borrowed \$12,000 from the bank for operating capital.
- The shop purchased \$600 worth of office supplies (for future use) from Office Supermarket for cash.
- During the month, the shop earned revenue of \$10,000 cash.
- The shop paid the monthly rent on the retail space in the amount of \$1,100.
- The shop paid the staff \$2,000.
- Other operating expenses for the month were \$1,375, which were paid in cash.
- On the last day of the month, the shop purchased equipment costing \$10,000 by signing a note payable with the bank.
- The company declared and paid a dividend of \$235 to Heidi, the firm's only shareholder.

Requirements

For each transaction in items (a)–(j), do the following:

- Identify whether it is an operating, investing, or financing transaction.
- Determine whether there is an increase, decrease, or no effect on the total assets of the business.
- Determine whether there is an increase, decrease, or no effect on net income.
- Indicate on which financial statement each amount would appear: the income statement (IS), the balance sheet (BS), the statement of changes in stockholder's equity (SE), or the statement of cash flows (CF). (Some will be shown on more than one statement.)

Solution:

Transaction	Operating (O), Investing (I), or Financing (F)	Effect on Assets	Effect on Net Income	Financial Statement
a.	F	Increase	No effect	BS, OE, CF
b.	O	Decrease	Decrease	IS, CF
c.	F	Increase	No effect	BS, CF
d.	O	Increase	No effect	BS, CF
e.	O	Increase	Increase	IS, CF
f.	O	Decrease	Decrease	IS, CF
g.	O	Decrease	Decrease	IS, CF
h.	O	Decrease	Decrease	IS, CF
i.	I/F notation	Increase	No effect	BS, note on CF
j.	F	Decrease	No effect	OE, CF

(Whenever cash is affected, the balance sheet is also affected.)

P1-55B. *Analyze business transactions and the effect on the financial statements. (LO 4).* Using transactions (a)–(j) in P1-54B, answer the following questions:

Requirements

- What is the cash balance at the end of Heidi's Smoothy Shop's first month of business?
- Does the shop have any liabilities at the end of the first month of business? If so, how much?
- Which assets will appear on the balance sheet at the end of the shop's first month of business?
- Did Heidi's generate a net income or a net loss during its first month of business? How much?

Solution:

1 Cash balance:	\$	22,000	contribution
		(325)	travel expense
		12,000	loan
		(600)	supplies
		10,000	sales revenue
		(1,100)	rent expense
		(2,000)	salaries expense
		(1,375)	operating expenses
		(235)	dividends
	<u>\$</u>	<u>38,365</u>	

2 Liabilities	\$	12,000	loan
		10,000	note payable
	<u>\$</u>	<u>22,000</u>	

3 Assets on balance sheet:

Cash
Office supplies
Equipment

4 Net income:

Revenue	\$	10,000
Expenses		(4,800)
Net income	<u>\$</u>	<u>5,200</u>

P1-56B. *Analyze effect of transactions on accounting equation. (LO 2, 4).* What will be the effects (increase, decrease, or no effect) on total assets, total liabilities, and total shareholders' equity in each of the following situations? When shareholders' equity changes, note whether it is contributed capital or retained earnings that changes. Identify whether each transaction is an operating, investing, or financing transaction.

	Total assets	=	Total liabilities	+	Shareholders' equity	
					Contributed capital	+ Retained earnings
1. Purchased land with cash	_____		_____		_____	_____
2. Performed services and received cash from customers	_____		_____		_____	_____
3. Received cash from the issue of shares of common stock	_____		_____		_____	_____
4. Paid cash for inventory	_____		_____		_____	_____
5. Sold inventory for cash	_____		_____		_____	_____

Solution:

	Stockholders' Equity						
	Total Assets	=	Total Liabilities	+	Contributed Capital	+	Retained Earnings
1. Purchased land with cash.	+						
	—						
	no net effect						
2. Performed services and received cash from customers	+						+
3. Received cash from the issue of shares of common stock.	+				+		
4. Paid cash for inventory.	+						
	—						
	no net effect						
5. Sold inventory for cash.	+						+
	—						—

1. investing
2. operating
3. financing
4. operating
5. operating

P1-57B. *Analyze business transactions and prepare the financial statements. (LO 4).* The following cash transactions took place during August, the first month of business for Comfy Cushions Cleaning, a corporation:

- a. Justin Snyder started the company by contributing \$30,000 cash and received common stock in exchange.
- b. The company earned and received \$10,000 cash in service revenue.
- c. The company paid employees \$3,000 cash.
- d. Miscellaneous expenses paid amounted to \$725 cash.
- e. The company declared and paid cash dividends of \$975.
- f. On August 31, the company borrowed \$13,300 from the local bank, to be repaid at the end of December.

Requirements

1. Show how each transaction affects the accounting equation.
2. Prepare the income statement, statement of changes in shareholder's equity, and the statement of cash flows for the month ended August 31 and the balance sheet at August 31.

Solution:

The Accounting Equation				
Assets		=	Liabilities	+ Shareholder's Equity
Cash	Other			Contributed Capital + Retained Earnings
a. 30,000				30,000 Common
b. 10,000				stock 10,000 Revenue
c. (3,000)				(3,000) Salary expense
d. (725)				(725) Misc. expense
e. (975)				(975) Dividends
f. 13,300			13,300 N/P	

Comfy Cushions Cleaning Income Statement For the month ended August 31	
Service revenue	\$ 10,000
Expenses:	
Salary expense	\$ 3,000
Miscellaneous expense	725
Total expenses	3,725
Net Income	<u>\$ 6,275</u>

Comfy Cushions Cleaning Statement of Changes in Shareholder's Equity For the month ended August 31	
Common stock:	
Beginning balance	\$ -
Contributions during the month	<u>30,000</u>
Ending common stock balance	\$ 30,000
Retained earnings:	
Beginning balance	-
+ Net income	6,275
- Dividends	<u>(975)</u>
Ending retained earnings balance	5,300
Total shareholder's equity	<u>\$35,300</u>

Comfy Cushions Cleaning Balance Sheet At August 31	
Assets	
Cash	\$48,600
Total assets	<u>\$48,600</u>
Liabilities and shareholder's equity	
Liabilities	
Short-term notes payable	\$13,300
Total liabilities	13,300
Shareholders' equity	
Common stock	30,000
Retained earnings	5,300
Total liabilities and shareholder's equity	<u>\$48,600</u>

Comfy Cushions Cleaning Statement of Cash Flows For the month ended January 31	
Cash from operations	
Cash collected from customers	\$10,000
Cash paid for miscellaneous expenses	(725)
Cash paid to employees	<u>(3,000)</u>
Net cash from operating activities	\$6,275
Cash from financing	
Proceeds from note payable	13,300
Proceeds from common stock issue	30,000
Payment of dividends	<u>(975)</u>
Net cash provided by financing activities	42,325
Net increase in cash during the year	<u>48,600</u>
Add beginning cash	-
Cash balance at January 31, 2007	<u>\$48,600</u>

P1-58B. *Retained earnings portion of the statement of changes in shareholders' equity.* (LO 4). The following information is for Larry's Book Store:

1. Retained earnings on January 1, 2010 were \$127,000.
2. In January, revenues were \$15,000 and expenses were \$10,000.
3. In February, revenues were \$17,500 and expenses were \$20,000.
4. In March, revenues were \$19,225 and expenses were \$13,000.
5. The company declared and paid dividends in March of \$1,000.

Requirement

Calculate the ending balance in retained earnings, and then prepare the retained earnings portion of the statement of changes in shareholders' equity for the quarter (three months) ended March 31, 2010.

Solution:

Retained earnings, January 1, 2010		\$ 127,000	Revenue: 51,725
Add: Revenues	January	15,000	Expenses: <u>(43,000)</u>
	February	17,500	NI 8,725
	March	19,225	
Deduct: Expenses	January	(10,000)	
	February	(20,000)	
	March	(13,000)	
Deduct: Dividends	March	(1,000)	
Retained earnings, March 31, 2010		<u>\$ 134,725</u>	

Larry's Book Store
Statement of Retained Earnings
For the Quarter Ended March 31, 2010

Beginning balance	\$ 127,000
Net income for the quarter	8,725
Dividends	<u>(1,000)</u>
Ending balance	<u>\$ 134,725</u>

Financial Statement Analysis

FSA1-1. *Identify items from the balance sheet. (LO 5).* Use Apple Inc.'s balance sheets given here to answer the questions that follow.

Apple Inc.
Consolidated Balance Sheets
(in millions, except share amounts)

Assets:	September 27, 2008	September 29, 2007
Current assets:		
Cash and cash equivalents	\$11,875	\$ 9,352
Short-term investments	12,615	6,034
Accounts receivable, less allowances of \$47 in each period	2,422	1,637
Inventories	509	346
Deferred tax assets	1,447	782
Other current assets	5,822	3,805
Total currents assets	34,690	21,956
Property, plant, and equipment, net	2,455	1,832
Goodwill	207	38
Acquired intangible assets, net	285	299
Other assets	1,935	1,222
Total assets	<u>\$39,572</u>	<u>\$25,347</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 5,520	\$ 4,970
Accrued expenses	8,572	4,310
Total current liabilities	14,092	9,280
Non-current liabilities	4,450	1,535
Total liabilities	18,542	10,815
Commitments and contingencies		
Stockholders' equity:		
Common stock, no par value; 1,800,000,000 shares authorized; 888,325,973 and 872,328,972 shares issued and outstanding, respectively	7,177	5,368
Retained earnings	13,845	9,101
Accumulated other comprehensive income	8	63
Total shareholders' equity	21,030	14,532
Total liabilities and shareholders' equity	<u>\$39,572</u>	<u>\$25,347</u>

Requirements

1. What date marks the end of Apple's most recent fiscal year?
2. Did Apple earn a net income or net loss during the most recent fiscal year? How can you tell?
3. Did the owners of Apple make any capital contributions during the most recent fiscal year (or did Apple get some new owners)?
4. Did Apple buy or sell any property, plant, or equipment during the most recent fiscal year? How can you tell?
5. On the last day of the most recent fiscal year, did Apple have any debts? If so, what was the total amount?

Solution:

- 1 Apple's most recent fiscal year ended September 27, 2008.
- 2 Apple's Retained Earnings balance increased during fiscal 2008, so the company had to have earned net income.
- 3 Apple's Common Stock balance increased during fiscal 2008, so the company issued additional shares of stock.
- 4 The balance in Apple's Property, Plant and Equipment account increased during fiscal 2008, so the company must have purchased some property, plant, or equipment.
- 5 Apple's liabilities totaled \$18,542 million at 9/27/2008.

FSA1-2. *Identify items from the statement of cash flows. (LO 5).* Use the statement of cash flows for Apple Inc. for the year ended September 27, 2008, given here to answer the questions that follow.

Apple Inc.
Statement of Cash Flows
For the Year Ended September 27, 2008

(in millions)	
Cash and cash equivalents, beginning of the year	\$ 9,352
Operating Activities:	
Net income	4,834
Adjustments to reconcile net income to cash generated by operating activities ...	4,762
Cash generated by operating activities	<u>9,596</u>
Investing Activities:	
Purchase of short-term investments	(22,965)
Proceeds from maturities of short-term investments	11,804
Proceeds from sales of short-term investments	4,439
Purchase of property, plant, and equipment	(1,091)
Other	(376)
Cash (used in) generated by investing activities	<u>(8,189)</u>
Financing Activities:	
Proceeds from issuance of common stock	483
Other financing activities (net)	633
Cash generated by financing activities	<u>1,116</u>
Increase in cash and cash equivalents	2,523
Cash and cash equivalents, end of the year	<u>\$11,875</u>

Requirements

1. Did Apple purchase any property, plant, or equipment during the year?
2. If you were to examine Apple's balance sheet at September 27, 2008, what amount would be shown for cash and cash equivalents?
3. Was cash generated from operations or used by operations? By what amount?
4. Did Apple receive any new contributions from owners during the year? How can you tell?
5. What was the primary source of cash for Apple for the year ended September 27, 2008? What does this say to you about Apple's operations for this year?

Solution:

- ¹ Apple purchased property, plant and equipment for \$1,091 million during fiscal 2008.
- ² Apple's cash and cash equivalents at 9/27/2008 is \$9,352 million.
- ³ Cash of \$9,596 million was generated by operating activities.
- ⁴ Proceeds from the issuance of common stock totaled \$483 million.
- ⁵ The single largest source of cash for Apple was from the maturity of short-term investments. Operating activities generated the second largest amount of cash for Apple. Typically, we expect operating activities to generate the most cash for a company. In this case, it could raise some questions about the operating affairs of the business.

FSA1-3. *Examine financial statements. (LO 2, 3, 5).* Use the selected pages from the annual report from Books-A-Million found in Appendix A to answer the following questions:

Requirements

1. What type of business is Books-A-Million and how is it organized?
2. Suppose you inherited \$10,000 when your great-uncle passed away and you want to invest in a promising company. Would you invest in Books-A-Million? What information in the annual report would be useful in your decision? Be specific. Is there any information that is not provided in the annual report that you would want to have before making your decision?
3. What is your opinion of the information in the annual report? For example, do you think it is accurate? Useful? Interesting? Informative? Why or why not?

Solution:

- 1 Books-A-Million is a national book retailer, organized as a corporation.
- 2 Answers will vary. Sample answer: I would be unlikely to invest in the company due to (1) declining net income, and (2) uncertainty in the economy. Useful information would include changes in assets, particularly long-term assets, and cash flows. Before I invested, I would want to know the company's plans for the future: Do they plan to continue expanding? How do they plan to finance their continued expansion? What is their dividend policy? I would also want to know if the company is being run in a responsible way. I'd also be interested in the book industry and the changes that may result from developing technologies (like the Kindle).
- 3 Answers will vary. Sample answer: Books-A-Million's 10-K is not shown in full, so students won't see the enormous amount of useful information it contains. In addition to the financial statements and the notes, it includes a great deal of useful discussion about the company's past performance and future plans. It also includes a letter from the company's independent auditors certifying the financial information is presented fairly.

Critical Thinking Problems

Risks and Controls

Being in business is risky. Imagine that you are starting a business. What type of business would you start? What are the most significant risks you face with your business? What controls would you put into effect to minimize those risks?

Solution:

What type of business would you start?

Answers will vary.

What are the most significant risks you would face with your business?

The risks faced by most small business include the lack of management systems, the lack of vision and purpose by the principals, and the lack of financial planning and review. Answers will vary according to the type of business.

What controls would you put in to minimize those risks?

- 1 Build an information system that provides feedback on what is and is not working.
- 2 Set goals and specific, measurable ways of achieving those goals.
- 3 Evaluate performance on a regular basis.

Group Problem

Look at the four basic financial statements for Books-A-Million, found in Appendix A at the back of the text. Find the total assets, liabilities, and shareholders' equity for the two most recent years. As a group, discuss the change in the company's financial position without looking at the income statement. Jot down your opinions. Then, study the income statement for the most recent year. Do the results support your opinions about the balance sheet changes? What information do these statements provide for your analysis? What additional information would be useful? After answering these questions as a group, look at the notes to the financial statements. Do the notes help answer any of your questions?

Make a list of 10 questions you have about the financial statements. Try to answer them and discuss why you would like answers to these questions. Save the list so you can check to see how many of the questions you are able to answer at the end of the course.

Solution:

(in thousands)	As of 1/31/09	As of 2/2/08
Assets	\$ 279,292	\$ 284,833
Liabilities	174,798	185,782
SH Equity	104,494	99,051

The company reduced its debt and earned a positive net income. Overall, assets decreased.

The income statement confirms the net income of \$10,574 thousand, although revenue and NI were down from the prior year.

The balance sheet shows us what assets the company owns and how it has financed those assets. We can see the total debt of the company and the total shareholders' equity. The income statement shows us how the company is performing financially. The statement of cash flows shows us the sources and uses of the company's cash. The statement of stockholders' equity shows us what changes have occurred in stockholders' equity during the year.

Answers will vary regarding what additional information would be useful. Sample answer: We would like to know how much of the net income is generated by store sales and Internet sales. We would also like to know why the company repurchased shares of its own stock.

The Notes contain a great deal of information about the individual financial statement items.

Questions about the financial statements:

Answers will vary. Sample answer:

- 1 How does the company decide how much to pay in dividends?
- 2 Why would a company repurchase shares of its own stock?
- 3 What is goodwill?
- 4 What are capital leases?
- 5 What is the allowance for doubtful accounts?
- 6 What are accrued expenses?
- 7 What is the difference between common and preferred stock?
- 8 Why do some income taxes get deferred?
- 9 What are prepayments and other under current assets?
- 10 What is other accumulated comprehensive income?

Ethics

Does your school have an honor code? If it does, it very likely addresses the issue of cheating on assignments or exams. Have you ever cheated on an exam? Have you ever "borrowed" a friend's assignment and used it to help you complete yours? Have you ever been a witness to a violation of the honor code by your peers? Compare Target's code of ethics (called Business Conduct Guide and found at <http://investors.target.com/phoenix.zhtml?c=65828&p=irol-govConduct>) to your school's honor code. How are they similar in purpose and scope?

Solution:

Answers will vary. Sample answer: Yes, my school has an honor code that addresses the issue of cheating on assignments and exams. As far as stacking up, I have never cheated on an exam or borrowed a friend's assignment, but I have witnessed a violation of my school's code of conduct. Like Target's Business Conduct Guide, my school's code of conduct focuses on good citizenship and "doing the right thing." Target's code of conduct describes the company's business practices for issues of interest to its employees, such as environmental laws, bribery, and product safety. My school's code of conduct focuses on issues of interest to its students such as academic honesty, computer use abuses, and trespassing.

Internet Exercise: Disney Corporation

The Walt Disney Company is a diversified worldwide entertainment company with interests in ABC TV, ESPN, film production, theme parks, publishing, a cruise line, Infoseek, and the NHL Mighty Ducks. By using the Disney Web site, you can explore vacation options and get Disney's latest financial information.

Please go to the Disney Web site at <http://corporate.disney.go.com/investors/>

IE1-1. What is the Walt Disney Company's key objective?

Go to Financial Information and click on the most recent annual report.

1. What are the key businesses of the Walt Disney Company? Identify whether you think the primary business activity is manufacturing, merchandising, or servicing for each key business segment.
2. Use the site map to find Financial Highlights. Identify the amount of total revenues and operating income for the most recent year. On which financial statement will you find these amounts reported? Is the Walt Disney Company a proprietorship, a partnership, or a corporation? How can you tell?
3. Use the Site Map to find Financial Review. What key business segment was the largest driver of operating revenue and operating income growth for the past year? Does this order surprise you? Explain why or why not.

Please note: Internet Web sites are constantly being updated. Therefore, if the information is not found where indicated, please explore the annual report further to find the information.

Solution:

Company: Walt Disney Company

IE1. The key objective of Walt Disney Company is "to be one of the world's leading producers and providers of entertainment and information, using its portfolio of brands to differentiate its content, services and consumer products."

- 1 The key businesses and primary business activities for each segment are:
 - 1 Parks and resorts - service
 - 2 Studio entertainment - manufacturing (produces motion pictures)
 - 3 Consumer products - merchandising
 - 4 Media networks - service
- 2 In 2008, Disney generated revenues of \$37.843 billion and had operating income of \$4.427 billion. These amounts would be reported on the income statement. Walt Disney is a corporation. The company's owners are shareholders.
- 3 In 2008, Media networks generated the greatest proportion of revenues with 43%. Parks and resorts earned 30% of Disney's revenues. Studio entertainment earned 19% and Consumer products earned 8% of company revenues.

	(in millions)	
	Revenue	
Media networks	\$ 16,116	43%
Parks and resorts	11,504	30%
Studio entertainment	7,348	19%
Consumer products	2,875	8%
	<u>\$ 37,843</u>	