Chapter 1

Financial Statements and Business Decisions

ANSWERS TO QUESTIONS

1. Accounting is a system that collects and processes (analyzes, measures, and records) financial information about an organization and reports that information to decision makers.

2. Financial accounting involves preparation of the four basic financial statements and related disclosures for external decision makers. Managerial accounting involves the preparation of detailed plans, budgets, forecasts, and performance reports for internal decision makers.

3. Financial reports are used by both internal and external groups and individuals. The internal groups are comprised of the various managers of the entity. The external groups include the owners, investors, creditors, governmental agencies, other interested parties, and the public at large.

4. Investors purchase all or part of a business and hope to gain by receiving part of what the company earns and/or selling the company in the future at a higher price than they paid. Creditors lend money to a company for a specific length of time and hope to gain by charging interest on the loan.

5. In a society each organization can be defined as a separate accounting entity. An accounting entity is the organization for which financial data are to be collected. Typical accounting entities are a business, a church, a governmental unit, a university and other nonprofit organizations such as a hospital and a welfare organization. A business typically is defined and treated as a separate entity because the owners, creditors, investors, and other interested parties need to evaluate its performance and its potential separately from other entities and from its owners.

6. *Name of Statement Alternative Title*

 (a) Income Statement (a) Statement of Earnings; Statement of Income; Statement of Operations

 (b) Balance Sheet (b) Statement of Financial Position

 (c) Audit Report (c) Report of Independent Accountants

7. The heading of each of the four required financial statements should include the following:

 (a) Name of the entity

 (b) Name of the statement

 (c) Date of the statement, or the period of time

 (d) Unit of measure

8. (a) The purpose of the income statement is to present information about the revenues, expenses, and the net income of the entity for a specified period of time.

 (b) The purpose of the balance sheet is to report the financial position of an entity at a given date, that is, to report information about the assets, obligations and stockholders’ equity of the entity as of a specific date.

 (c) The purpose of the statement of cash flows is to present information about the flow of cash into the entity (sources), the flow of cash out of the entity (uses), and the net increase or decrease in cash during the period.

 (d) The statement of stockholders’ equity reports the changes in each of the company’s stockholders’ equity accounts during the accounting period including issue and repurchase of stock and the way that net income and distribution of dividends affected the retained earnings of the company during that period.

9. The income statement and the statement of cash flows are dated “For the Year Ended December 31, 2013,” because they report the inflows and outflows of resources during a period of time. In contrast, the balance sheet is dated “At December 31, 2013,” because it represents the resources, obligations and stockholders’ equity at a specific date.

10. Assets are important to creditors and investors because assets provide a basis for judging whether sufficient resources are available to operate the company. Assets are also important because they could be sold for cash in the event the company goes out of business. Liabilities are important to creditors and investors because the company must be able to generate sufficient cash from operations or further borrowing to meet the payments required by debt agreements. If a business does not pay its creditors, the law may give the creditors the right to force the sale of assets sufficient to meet their claims.

11. Net income is the excess of total revenues over total expenses. Net loss is the excess of total expenses over total revenues.

12. The equation for the income statement is Revenues - Expenses = Net Income (or Net Loss if the amount is negative). Thus, the three major items reported on the income statement are (1) revenues, (2) expenses, and (3) net income.

13. The equation for the balance sheet (also known as the basic accounting equation) is: Assets = Liabilities + Stockholders’ Equity. Assets are the probable (expected) future economic benefits owned by the entity as a result of past transactions. They are the resources owned by the business at a given point in time such as cash, receivables, inventory, machinery, buildings, land, and patents. Liabilities are probable (expected) debts or obligations of the entity as a result of past transactions which will be paid with assets or services in the future. They are the obligations of the entity such as accounts payable, notes payable, and bonds payable. Stockholders’ equity is financing provided by owners of the business and operations. It is the claim of the owners to the assets of the business after the creditor claims have been satisfied. It may be thought of as the residual interest because it represents assets minus liabilities.

14. The equation for the statement of cash flows is: Cash flows from operating activities + Cash flows from investing activities + Cash flows from financing activities = Change in cash for the period. The net cash flows for the period represent the increase or decrease in cash that occurred during the period. Cash flows from operating activities are cash flows directly related to earning income (normal business activity including interest paid and income taxes paid). Cash flows from investing activities include cash flows that are related to the acquisition or sale of productive assets used by the company. Cash flows from financing activities are directly related to the financing of the enterprise itself.

15. The retained earnings equation is: Beginning Retained Earnings + Net Income - Dividends = Ending Retained Earnings. It begins with beginning-of-the-year Retained Earnings which is the prior year’s ending retained earnings reported on the balance sheet. The current year's Net Incomereported on the income statement is added and the current year's Dividends are subtracted from this amount. The ending Retained Earnings amount is reported on the end-of-period balance sheet.

16. Marketing managers and credit managers use customers' financial statements to decide whether to extend them credit for their purchases. Purchasing managers use potential suppliers' financial statements to judge whether the suppliers have the resources necessary to meet current and future demand. Human resource managers use financial statements as a basis for contract negotiations, to determine what pay rates the company can afford. The net income figure even serves as a basis to pay bonuses not only to management, but to other employees through profit sharing plans.

17. The Securities and Exchange Commission (SEC) is the U.S. government agency which determines the financial statements that public companies must provide to stockholders and the measurement rules used in producing those statements. The Financial Accounting Standards Board (FASB) is the private sector body given the primary responsibility to work out the detailed rules which become generally accepted accounting principles.

18. Management is responsible for preparing the financial statements and other information contained in the annual report and for the maintenance of a system of internal accounting policies, procedures and controls. These measures are intended to provide reasonable assurance, at appropriate cost, that transactions are processed in accordance with company authorization as well as properly recorded and reported in the financial statements, and that assets are adequately safeguarded. Independent auditors examine the financial reports (prepared by management) and the underlying records to assure that the reports represent what they claim and conform with generally accepted accounting principles (GAAP).

19. A sole proprietorship is an unincorporated business owned by one individual. A partnership is an unincorporated association of two or more individuals to carry on a business. A corporation is a business that is organized under the laws of a particular state whereby a charter is granted and the entity is authorized to issue shares of stock as evidence of ownership by the owners (i.e., stockholders).

20. A CPA firm normally renders three services: auditing, management advisory services, and tax services. Auditing involves examination of the records and financial reports to determine whether they “fairly present” the financial position and results of operations of the entity. Management advisory services involve management advice to the individual business enterprises and other entities. It is like a consulting firm. Tax services involve providing tax planning advice to clients (both individuals and businesses) and preparation of their tax returns.

ANSWERS TO MULTIPLE CHOICE

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 1. b)
 | 1. d)
 | 1. d)
 | 1. c)
 | 1. a)
 |
| 1. d)
 | 1. a)
 | 1. a)
 | 1. c)
 | 1. b)
 |

Authors' Recommended Solution Time

(Time in minutes)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| *Mini-exercises* | *Exercises* | *Problems* | *Alternate Problems* | *Cases and Projects* |
| *No.* | *Time* | *No.* | *Time* | *No.* | *Time* | *No.* | *Time* | *No.* | *Time* |
| 1 | 5 | 1 | 12 | 1 | 45 | 1 | 45 | 1 | 20 |
| 2 | 5 | 2 | 12 | 2 | 45 | 2 | 45 | 2 | 30 |
| 3 | 5 | 3 | 12 | 3 | 45 | 3 | 45 | 3 | 30 |
|  |  | 4 | 20 | 4 | 45 |  |  | 4 | 60 |
|  |  | 5 | 25 |  |  |  |  | 5 | 30 |
|  |  | 6 | 20 |  |  |  |  | 6 | 20 |
|  |  | 7 | 15 |  |  |  |  | 7 | \* |
|  |  | 8 | 25 |  |  |  |  |  |  |
|  |  | 9 | 25 |  |  |  |  | *Continuing Case* |
|  |  | 10 | 25 |  |  |  |  | 1 | 45 |
|  |  | 11 | 30 |  |  |  |  |  |  |
|  |  | 12 | 15 |  |  |  |  |  |  |
|  |  | 13 | 12 |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |

\* Due to the nature of these cases and projects, it is very difficult to estimate the amount of time students will need to complete the assignment. As with any open-ended project, it is possible for students to devote a large amount of time to these assignments. While students often benefit from the extra effort, we find that some become frustrated by the perceived difficulty of the task. You can reduce student frustration and anxiety by making your expectations clear. For example, when our goal is to sharpen research skills, we devote class time discussing research strategies. When we want the students to focus on a real accounting issue, we offer suggestions about possible companies or industries.

MINI-EXERCISES

**M1–1.**

|  |  |  |
| --- | --- | --- |
|  | **Element** | **Financial Statement** |
| B | (1) Expenses | A. Balance sheet |
| D | (2) Cash flow from investing activities | B. Income statement |
| A | (3) Assets | C. Statement of stockholders’ equity |
| C\* | (4) Dividends | D. Statement of cash flows |
| B | (5) Revenues |  |
| D | (6) Cash flow from operating activities |  |
| A | (7) Liabilities |  |
| D | (8) Cash flow from financing activities |  |

\*Dividends paid in cash are also subtracted in the Financing section of the Statement of Cash Flows

**M1–2.**

|  |  |
| --- | --- |
| SE | 1. Retained earnings
 |
| A | 1. Accounts receivable
 |
| R | 1. Sales revenue
 |
| A | 1. Property, plant, and equipment
 |
| E | 1. Cost of goods sold expense
 |
| A | 1. Inventories
 |
| E | 1. Interest expense
 |
| L | 1. Accounts payable
 |
| A | 1. Land
 |

**M1–3.**

|  |  |
| --- | --- |
| **Abbreviation** | **Full Designation** |
| (1) | CPA | Certified Public Accountant |
| (2) | GAAP | Generally Accepted Accounting Principles |
| (3) | SEC | Securities and Exchange Commission |
| (4) | FASB | Financial Accounting Standards Board |
|  |  |  |
|  |  |  |

EXERCISES

**E1–1.**

 **Term or Abbreviation Definition**

|  |  |  |  |
| --- | --- | --- | --- |
| JF H EADILCKGBM | (1)(2)(3)(4)(5)(6)(7)(8)(9)(10)(11)(12)(13) | SECAuditSole proprietorshipCorporationAccountingAccounting entityAudit reportPublicly tradedPartnershipFASBCPAUnit of measureGAAP | 1. A system that collects and processes financial information about an organization and reports that information to decision makers.
2. Measurement of information about an entity in terms of the dollar or other national monetary unit.
3. An unincorporated business owned by two or more persons.
4. The organization for which financial data are to be collected (separate and distinct from its owners).
5. An incorporated entity that issues shares of stock as evidence of ownership.
6. An examination of the financial reports to ensure that they represent what they claim and conform with generally accepted accounting principles.
7. Certified Public Accountant.
8. An unincorporated business owned by one person.
9. A report that describes the auditor’s opinion of the fairness of the financial statement presentations and the evidence gathered to support that opinion.
10. Securities and Exchange Commission.
11. Financial Accounting Standards Board.
12. A company with stock that can be bought and sold by investors on established stock exchanges.
13. Generally accepted accounting principles.
 |

**E1–2.**

|  |  |
| --- | --- |
| A | 1. Accounts receivable
 |
| A | 1. Cash and cash equivalents
 |
| R | 1. Net sales
 |
| L | 1. Notes payable
 |
| L | 1. Taxes payable
 |
| SE | 1. Retained earnings
 |
| E | 1. Cost of products sold
 |
| E | 1. Marketing, administrative, and other operating expenses
 |
| E | 1. Income taxes
 |
| L | 1. Accounts payable
 |
| A | 1. Land
 |
| A | 1. Property, plant, and equipment
 |
| L | 1. Long-term debt
 |
| A | 1. Inventories
 |
| E | 1. Interest expense
 |

**E1–3.**

|  |  |  |  |
| --- | --- | --- | --- |
| L | 1. Notes payable to banks
 | A | 1. Machinery and equipment
 |
| E | 1. General and administrative
 | R | 1. Net sales
 |
| L | 1. Accounts payable
 | A | 1. Inventories
 |
| L | 1. Dividends payable
 | E | 1. Marketing, selling, and advertising
 |
| SE | 1. Retained earnings
 | A | 1. Buildings
 |
| A | 1. Cash and cash equivalents
 | A | 1. Land
 |
| A | 1. Accounts receivable
 | L | 1. Income taxes payable
 |
| E | 1. Provision for income taxes\*
 | E | 1. Distribution and warehousing costs
 |
| E | 1. Cost of goods sold
 | A | 1. Investments (in other companies)
 |

\*Note that “Provision for income taxes” is a common synonym for “Income tax expense.”

**E1–4.**

Honda Motor Corporation

Balance Sheet

as of March 31, 2011

(in billions of Yen)

|  |  |
| --- | --- |
| **Assets** |  |
| Cash and cash equivalents |  1,279  |
| Trade accounts, notes, and other receivables | 788 |
| Inventories | 900 |
| Investments | 640 |
| Net property, plant and equipment | 1,939 |
| Other assets |  6,025 |
| Total assets | 11,571 |
|  |  |
| **Liabilities** |  |
| Accounts payable and other current liabilities  |  3,568 |
| Long-term debt | 2,043 |
| Other liabilities |  1,377 |
| Total liabilities |  6,988 |
| **Stockholders’ Equity** |  |
| Common stock | 259 |
| Retained earnings |  4,324 |
| Total stockholders’ equity |  4,583 |
| Total liabilities and stockholders’ equity | 11,571 |

**E1–5.**

Req. 1

NEW WORLD BOOK STORE

Balance Sheet

At December 31, 2014

|  |  |  |  |
| --- | --- | --- | --- |
| **ASSETS** |  | **LIABILITIES** |  |
| Cash | $75,600 | Accounts payable  | $12,000 |
| Accounts receivable | 39,000 | Note payable | 3,000 |
| Store and office equipment | 73,000 | Interest payable  | 300 |
|  |  |  Total liabilities | 15,300 |
|  |  |  |  |
|  |  | **STOCKHOLDERS’ EQUITY** |  |
|  |  | Common stock | 160,000 |
|  |  | Retained earnings | 12,300 |
|  |  |  Total stockholders’ equity | 172,300 |
| Total assets | $187,600 | Total liabilities and stockholders' equity | $187,600 |

Req. 2

Net income for the year was $12,300. This is the first year of operations and no dividends were declared or paid to stockholders; therefore, the ending retained earnings of $12,300 includes net income for one year.

**E1–6.**

CAMPUS CONNECTION

Income Statement

For the Month of January 2014

Revenues:

 Sales: Cash $150,000

 On credit 2,500

 Total sales revenue $152,500

Expenses:

 Cost of goods sold 70,000

 Salaries, rent, supplies, and other

 expenses (paid in cash) 37,000

 Utilities 900

 Total expenses 107,900

Net Income $44,600

**E1–7.**

WALGREEN CO.

Income Statement

For the Year ended August 31, 2011

(in millions)

|  |  |  |
| --- | --- | --- |
| Revenues: |  |  |
|  Net sales  | $72,184  |  |
|  Other Income |  434  |  |
|  Total revenues/ income |  | $72,618  |
| Expenses: |  |  |
|  Cost of sales | 51,692 |  |
|  Selling, general and administration expense | 16,561 |  |
|  Interest Expense |  71 |   |
|  Total expenses |  |  68,324 |
| Pretax income |  | 4,294  |
|  Income tax expense |  |  1,580 |
| Net earnings |  | $2,714  |

\*Note that “Provision for income taxes” is a common synonym for “Income tax expense.”

**E1–8.**

NEIGHBORHOOD REALTY, INCORPORATED

Income Statement

For the Year Ended December 31, 2015

Revenues:

 Commissions earned ($150,900+$16,800) $167,700

 Rental service fees 20,000

 Total revenues $187,700

Expenses:

 Salaries expense 62,740

 Commission expense 35,330

 Payroll tax expense 2,500

 Rent expense ($2,475+$225)\* 2,700

 Utilities expense 1,600

 Promotion and advertising expense 7,750

 Miscellaneous expenses 500

 Total expenses (excluding income taxes) 113,120

Pretax income 74,580

 Income tax expense 24,400

Net Income $50,180

\*$2,475 has been paid for 11 months ($225 per month) plus $225 owed for December.

**E1–9.**

Net Income (or Loss) = Revenues - Expenses

Assets = Liabilities + Stockholders’ Equity

A Net Income = $93,500 - $76,940 = $16,560;

Stockholders’ Equity = $140,200 - $66,500 = $73,700.

B Total Revenues = $75,834 + $14,740 = $90,574;

 Total Liabilities = $107,880 - $77,500 = $30,380.

C Net Loss = $68,120 - $76,430 = ($8,310);

 Stockholders’ Equity = $98,200 - $69,850 = $28,350.

D Total Expenses = $55,804 - $21,770 = $34,034;

 Total Assets = $20,300 + $78,680 = $98,980.

E Net Income = $84,840 - $75,320 = $9,520;

 Total Assets = $25,520 + $80,000 = $105,520.

**E1–10.**

Net Income (or Loss) = Revenues - Expenses

Assets = Liabilities + Stockholders’ Equity

A Net Income = $242,300 - $196,700 = $45,600;

Stockholders’ Equity = $253,500 - $75,000 = $178,500.

B Total Revenues = $176,500 + $29,920 = $206,420;

 Total Liabilities = $590,000 - $350,600 = $239,400.

C Net Loss = $73,500 - $91,890 = ($18,390);

 Stockholders’ Equity = $260,400 - $190,760 = $69,640.

D Total Expenses = $35,840 - $9,840 = $26,000;

 Total Assets = $190,430 + $97,525 = $287,955.

E Net Income = $224,130 - $209,500= $14,630;

 Total Assets = $173,850 + $360,100 = $533,950.

**E1–11.**

PAINTER CORPORATION

Income Statement

For the Month of January 2013

Total revenues $305,000

Less: Total expenses (excluding income tax) 189,000

Pretax income 116,000

Less: Income tax expense 35,000

Net income $ 81,000

PAINTER CORPORATION

Balance Sheet

At January 31, 2013

Assets

 Cash $ 65,150

 Receivables from customers 44,700

 Merchandise inventory 94,500

Total assets $204,350

Liabilities

 Payables to suppliers $25,950

 Income taxes payable 35,000

 Total liabilities 60,950

Stockholders' Equity

 Common stock (2,600 shares) 62,400

 Retained earnings *(from income statement above)* 81,000

Total stockholders’ equity 143,400

Total liabilities and stockholders' equity $204,350

**E1–12.**

CLINT’S STONEWORK CORPORATION

Statement of Stockholders’ Equity

For the Year Ended December 31, 2014

 Common Stock Retained Earnings

 Balance December 31, 2013\* $100,000 $16,800

 Net income 42,000

 Dividends $100,000 (18,700)

 Balance December 31, 2014 $100,000 $40,100

\* Beginning retained earnings + Net income – Dividends = Ending retained earnings

 For 2013: $0 + 31,000 – 14,200 = $16,800;

 Ending retained earnings for 2013 becomes beginning retained earnings for 2014.

**E1–13.**

|  |  |
| --- | --- |
| (I) | 1. Purchases of property, plant, and equipment
 |
| O | 1. Cash received from customers
 |
| (F) | 1. Cash paid for dividends to stockholders
 |
| (O) | 1. Cash paid to suppliers
 |
| (O) | 1. Income taxes paid
 |
| (O) | 1. Cash paid to employees
 |
| I | 1. Cash proceeds received from sale of investment in another company
 |
| (F) | 1. Repayment of borrowings
 |

**ALTERNATE PROBLEMS**

**AP1–1.**

Req. 1

INFLUENCE CORPORATION

Income Statement

For the Year Ended June 30, 2014

Total sales revenue (given) $100,000

Total expenses (given) 68,500

Pretax income 31,500

Income tax expense ($31,500 x 30%) 9,450

Net income $22,050

Req. 2

INFLUENCE CORPORATION

Statement of Stockholders’ Equity

For the Year Ended June 30, 2014

 Common Stock Retained Earnings

Balance, July 1, 2013 $ 0 $ 0

Common stock issuance (given) 62,000

+Net income (from req. 1) 22,050

–Dividends (given) $ 62,000 0

Balance, June 30, 2014 $ 62,000 $ 22,050

Req. 3

INFLUENCE CORPORATION

Balance Sheet

At June 30, 2014

 Assets

Cash (given) $13,150

Receivables from customers (given) 10,900

Inventory of merchandise (given) 27,000

Equipment (given) 66,000

Total assets $117,050

 Liabilities

Accounts payable (given) $31,500

Salary payable (given) 1,500

 Total liabilities $ 33,000

 Stockholders' Equity

Common stock (given) $62,000

Retained earnings (from req. 2) 22,050

 Total stockholders' equity 84,050

Total liabilities and stockholders' equity $117,050

**AP1–2.**

Req. 1

LIST ELECTRIC REPAIR COMPANY, INC.

Income Statement

For the Three Months Ended December 31, 2014

Revenues from services:

Electric repair services–cash $32,000

 –credit 3,500

 Total revenues $35,500

Expenses:

Electrician's assistant (wages) 7,500

### Payroll taxes 175

Supplies used on jobs 9,500

Oil, gas, and maintenance on truck 1,200

Insurance 700

Rent ($500+$250) 750

Utilities and telephone 825

Miscellaneous expenses 600

Depreciation of truck and tools (use) 1,200

 Total expenses 22,450

Pretax Income 13,050

 Income taxes 3,930

Net Income $ 9,120

Req. 2

Because the above report reflects only revenues, expenses, and net income, it is reasonable to suppose that Sam would have need for the following:

(1) A statement that reports for the business, at the end of 2014, each asset (name and amount such as Cash, $XX), and each liability (such as Income taxes payable, $XX), and stockholders' equity; that is, a balance sheet.

(2) A statement of the sources and uses of cash during the period; that is, a statement of cash flows.

(3) A statement of stockholders’ equity that shows the change in common stock and how net income and dividends affect retained earnings on the balance sheet.

**AP1–3.**

 ***Req. 1 Req. 2–Explanation***

*Transaction Income Cash*

 (a) +$85,000 +$70,000 All services performed increase income;

 cash received during the period was,

 $85,000 – 15,000 = $70,000.

 (b) –0– +25,000 Cash borrowed is not income.

 (c) –0– –8,000 Purchase of the truck does not represent

 an expense until it is used (it is an asset);

 cash outflow was $8,000.

 (d) –36,000 –30,000 All of the wages incurred reduce income,

 $36,000; cash paid during the quarter was, $36,000 x 5/6 = $30,000. The $6,000

 owed will be paid on the next payroll date.

 (e) –3,000 –4,000 Not all of the supplies were used; expense is the amount used, $4,000 – 1,000 = $3,000.

 Cash paid during the quarter was $4,000.

 (f) –31,000 –15,500 All expenses incurred reduce income; cash expended was, $31,000 – 15,500 = $15,500.

Based only

on the above:

Income (loss) $15,000

Cash inflow

(outflow) $ 37,500

**CASES AND PROJECTS**

## ANNUAL REPORT CASES

**CP1–1.**

1. It sells its own brand of high quality, on-trend clothing, accessories, and personal care products targeting 15 to 25 year-old customers.
2. The company’s most recent fiscal year ended on January 28, 2012.
3. a. Balance Sheets–2 years
4. Income Statements–3 years
5. Cash Flow Statements–3 years
6. Yes, it is audited by independent CPAs, as indicated by the ”Report of Independent Registered Public Accounting Firm” on page 69 of the annual report.
7. Its total assets increased from $1,879,998,000 to $1,950,802,000. The instructor should note that the reported numbers are in thousands.
8. As of January 28, 2012, the company had $378,426,000 in inventory.
9. Assets = Liabilities\* + Stockholders’ Equity

$1,950,802,000 = $533,951,000 + $1,416,851,000

 \*Liabilities are determined by either adding current ($405,401,000) and long term liabilities ($128,550,000) or by solving the accounting equation: Assets ($1,950,802,000) = Liabilities + Stockholders’ Equity ($1,416,851,000)

**CP1–2.**

1. Net income was $185,251 thousand or $185,251,000 for the year ended January 31, 2012. This is disclosed on the income statement. The instructor should note that the reported numbers are in thousands. Some students will erroneously report income as $185,251. Students should also be warned that different companies often use different terminology—some companies may use the term “net earnings” to describe net income.
2. Net sales were $2,473,801,000. This is also disclosed on the income statement.
3. Inventory is $250,073,000. This is disclosed on the balance sheet.
4. Cash and cash equivalents decreased by $194,984,000 during the year. This amount can be computed from the balance sheet or it can be found on the statement of cash flows.
5. The auditor is Deloitte & Touche LLP. This is found on the auditor’s report (in this case, called the “report of independent registered public accounting firm”).

**CP1–3.**

1. American Eagle Outfitters had total assets of $1,950,802,000 at the end of the most recent year, whereas Urban Outfitters had total assets of $1,483,708,000. Clearly American Eagle Outfitters is the larger of the two companies in terms of total assets at the end of the most recent year.

2. Urban Outfitters had net sales of $2,473,801,000 in the most recent year, while American Eagle Outfitters had greater net sales in the amount of $3,159,818,000. Again, American Eagle Outfitters is the larger of the two companies in terms of net sales.

3. In the most recent year, Urban Outfitters had a decrease in total assets of ($1,483,708,000-$1,794,321,000)/($1,794,321,000) = -17.3%, while American Eagle Outfitters had growth in total assets of ($1,950,802,000 - $1,879,998,000)/($1,879,998,000) = 3.8%.

Similarly, Urban Outfitters had growth in net sales of ($2,473,801,000 - $2,274,102,000)/($2,274,102,000) = 8.8%, while American Eagle Outfitters had lower growth in net sales of ($3,159,818,000 - $2,967,559,000)/($2,967,559,000) = 6.5%.

Urban Outfitters is growing faster in sales, but American Eagle grew in total assets while Urban Outfitters declined.

## FINANCIAL REPORTING AND ANALYSIS CASES

**CP1–4.**

Req. 1–Deficiencies:

(1) Heading: titles of the reports are missing and dates are not in proper form.

(2) Income statement should show revenues and expenses separately.

(3) “Profit earned in 2012” should be “Net income.”

(4) Balance sheet should separately report assets, liabilities, and stockholders' equity.

(5) Retained earnings, $32,250, should be reported under stockholders' equity.

(6) Due from customers, $13,000, should be reported under assets.

(7) Supplies on hand, $15,000, should be reported under assets.

(8) Accumulated depreciation, $12,000, should be subtracted from service vehicles.

**CP1–4. (continued)**

Req. 2–Financial Statements:

PERFORMANCE CORPORATION

Income Statement

For the Year Ended December 31, 2012

Revenues:

Sales $180,000

Services 52,000

 Total revenues $232,000

Expenses:

Cost of goods sold $ 90,000

Selling expenses 25,000

Depreciation expense 12,000

Salaries and wages 62,000

 Total expenses (excluding income tax) 189,000

Pretax income 43,000

Income tax expense (25% x $43,000) 10,750

Net income $32,250

PERFORMANCE CORPORATION

Balance Sheet

At December 31, 2012

Assets

Cash $ 32,000

Accounts receivable (from customers) 13,000

Merchandise inventory (for resale) 42,000

Supplies inventory (for use in rendering services) 15,000

Service vehicles $50,000

Less accumulated depreciation (12,000) 38,000

 Total assets $140,000

Liabilities

Accounts payable (to suppliers) $17,750

Note payable (to bank) 25,000

 Total liabilities 42,750

Stockholders' equity

Common stock, 6,500 shares $65,000

Retained earnings 32,250

 Total stockholders' equity 97,250

 Total liabilities and stockholders' equity $140,000

*CRITICAL THINKING CASES*

**CP1–5.**

Req. 1 You should forcefully assert the need for an independent audit of the financial statements each year because this is the best way to assure credibility–conformance with GAAP, completeness and absence of bias.

 You should firmly reject “Uncle Ray” as the auditor because there is no evidence about his competence as an accountant or auditor. Also, he is related to the partner who prepares the financial statements; there is a conflict of interest.

Req. 2 You should strongly recommend the selection of an independent CPA in public practice because the financial statements should be audited by a competent and independent professional who must follow prescribed accounting and auditing standards on a strictly independent basis. An audit by “Uncle Ray” would not meet any of these requisites, particularly the important one in this case–independence (and absence of bias).

**CP1–6.**

The textbook does not explicitly cover the elements of independence. The case is designed to permit the students to develop their own values. We have found that it is useful to emphasize the difference between independence in fact and in appearance during these discussions.

1. Most students feel that there is no problem with independence if the stock held is immaterial in amount. When asked about a possible headline that might read “Auditor who was shareholder is accused of fraud,” most students see a problem with the appearance. In fact, the AICPA does not apply a materiality threshold where there is a direct financial interest. Any holding of stock is a problem.

2. This is an example of an indirect holding of stock. A materiality threshold is applied in these situations. There could be a question of independence if the auditor held a material interest in the mutual fund (relative to her net worth) and the mutual fund held a material interest in the company that she audited.

3. The AICPA Code of Professional Conduct applies only to audit professionals who are members (though most state laws incorporate similar rules). Bob's employers may want to assign him to a different company but there is no conflict with the Code.

4. Clearly there is an ethics violation in this case because she would audit statements that covered a period of time where she was responsible for the accounting operations of the company. This is a problem both in appearance and in fact.

5. The original Code indicated that a loan from a bank that was made under normal lending procedures, terms, and requirements was not an impairment of independence. This issue is currently under a review that will probably result in a modification of the rule. It is an excellent example of how ethics rules can change over time. The savings and loan debacle with the resulting lawsuits has caused the profession to reconsider the appearance of loans to auditors.

## FINANCIAL REPORTING AND ANALYSIS PROJECTS

**CP1–7.**

The solutions to this case will depend on the company and/or accounting period selected for analysis.

**CONTINUING CASE**

**CC1–1.**

Req. 1

|  |
| --- |
| Penny’s Pool Service & Supply. |
| Income Statement  |
| For the Year Ended December 31, 2014  |

Revenues

 Sales revenue $ 60,000

Expenses

 Cost of supplies used 8,200

 Wage expense 24,000

 Other administrative expense 4,500

 Total expenses 36,700

Pretax income 23,300

 Income tax expense 4,000

Net income $19,300

Req. 2

|  |
| --- |
| Penny’s Pool Service & Supply. |
| Statement of Stockholders' Equity |
| For the Year Ended December 31, 2014  |
|   | Common Stock  | Retained Earnings |
| Balance December 31, 2013 |  $ 0  |  $ 0  |
| Issue common stock | 20,000 |  |
| Net income for 2014 |   |  19,300  |
| Dividends for 2014 |   |  (10,000) |
| Balance December 31, 2014 |  $ 20,000  |  $ 9,300  |

**CC1.****(continued)**

Req. 3

|  |
| --- |
| Penny’s Pool Service & Supply |
| Balance Sheet |
| At December 31, 2014 |
| Assets: |   |
| Cash  |  $ 2,900  |
| Accounts receivable |  2,300  |
| Inventories | 4,600  |
|  Equipment |  28,000  |
| Total assets |  $ 37,800  |
| Liabilities and Stockholders' Equity: |   |
| Liabilities  |   |
| Accounts payable |  $3,500  |
| Notes payable to banks |  5,000  |
| Total liabilities  | 8,500  |
| Stockholders' equity |   |
| Common Stock |  20,000  |
| Retained earnings | 9,300  |
| Total stockholders' equity |  29,300  |
| Total liabilities and stockholders' equity |  $ 37,800  |