# Chapter 1

# A Framework for Financial Accounting

# review Questions

Question 1-1 (LO 1-1)

Accounting is the language of business. Whereas a basic math class might involve adding, subtracting, and solving for unknown variables, accounting involves learning to measure business transactions and communicating those measurements in a format that is generally understood by decision makers.

Question 1-2 (LO 1-1)

Those interested in making decisions about a company include investors, creditors, customers, suppliers, managers, employees, competitors, regulators, tax authorities, and local communities.

Question 1-3 (LO 1-1)

Financial accounting seeks to measure business activities of a company and to communicate those measurements to *external* parties for decision-making purposes. The two primary external, or outside the firm, users of financial accounting information are investors and creditors. Managerial accounting deals with the methods accountants use to provide information to an organization’s *internal* users, that is, its own managers.

Question 1-4 (LO 1-1)

The two primary functions of financial accounting are to measure business activities of a company and to communicate information about those activities to investors and creditors for decision-making purposes.

Question 1-5 (LO 1-2)

The three basic business activities are financing, investing, and operating activities. Financing activities are transactions that raise cash needed to operate the business. Investing activities typically include the purchase or disposal of long-term resources such as land, buildings, equipment, and machinery. Operating activities include the primary operations of the company, providing products and services to customers and the associated costs of doing so, like utilities, taxes, advertising, wages, rent, and maintenance.

Question 1-6 (LO 1-2)

Typical financing activities would include selling stock and paying dividends to investors, as well as borrowing and repaying debt to creditors.

Question 1-7 (LO 1-2)

Typical investing activities would include the purchase or disposal of land, casino buildings, hotels, gaming tables, chairs, cleaning equipment, and food preparation machines.

*Answers to Review Questions (continued)*

Question 1-8 (LO 1-2)

Typical operating activities would include the sale of software and consulting services, as well as costs related to salaries, research, utilities, advertising, rent, and taxes.

Question 1-9 (LO 1-2)

The three major legal forms of business organizations include sole proprietorship, partnership, and corporation? A corporation is chosen by most of the largest companies in the United States.

Question 1-10 (LO 1-2)

Assets: Resources owned.

Liabilities: Amounts owed.

Stockholders’ equity: Owners’ claims to resources.

Dividends: Distributions to stockholders.

Revenues: Sales of products or services to customers.

Expenses: Costs of selling products or services.

Question 1-11 (LO 1-2)

The major advantage of a corporation is limited liability. Stockholders of a corporation are not held personally responsible for the financial obligations of the corporation. Owners of sole proprietorships or partnerships remain personally liable for activities of the business. Corporations have the disadvantages of double taxation and generally higher tax rates compared to sole proprietorships and partnerships. The advantage of the sole proprietorship and partnership forms of business is that income is taxed only once, and at the personal income tax rate.

Question 1-12 (LO 1-3)

1. Income statement: Reports the company’s revenues and expenses during an interval of time. If revenues exceed expenses, then the company reports net income. If expenses exceed revenues, then the company reports a net loss.

2. Statement of stockholders’ equity: Summarizes the changes in stockholders’ equity from net income, dividends, and stock issuances during an interval of time.

3. Balance sheet: Presents the financial position of the company on a particular date. It shows that assets equal liabilities plus stockholders’ equity.

4. Statement of cash flows: Cash activities related to operating, investing, and financing activities during an interval of time.

Question 1-13 (LO 1-3)

Balances of accounts reported in the income statement, statement of stockholders’ equity, and statement of cash flows reflect activity from the beginning of the period through the end of the period. Balances of accounts reported in the balance sheet reflect the financial position of the company as of a single date, the end of the period.

*Answers to Review Questions (continued)*

Question 1-14 (LO 1-3)

Basic revenues would include sale of products (such as toys, dolls, and games) and services (such as theme park tickets). Expenses include cost of merchandise sold, employee salaries, utilities, advertising, taxes, interest, and legal fees.

Question 1-15 (LO 1-3)

The accounting equation is: Assets = Liabilities + Stockholders’ Equity. The format of the balance sheet follows the accounting equation.

Question 1-16 (LO 1-3)

Assets would include items such as merchandise inventory, office supplies, buildings, land, trucks, and equipment. Liabilities would include items such as amounts owed to employees, suppliers, taxing authorities, and lenders.

Question 1-17 (LO 1-3)

Retained earnings represent the cumulative amount of net income earned over the life of the company that has *not* been distributed to stockholders as dividends. Net income is shown in the income statement and retained earnings are reported in the balance sheet. Thus, retained earnings represent a balance sheet account which reflects the cumulative result of income statements over the life of the company (less any dividends).

Question 1-18 (LO 1-3)

The statement of cash flows reports operating, investing, and financing cash flows. Examples of each include:

Operating – selling merchandise, paying employee salaries, and paying for advertisement.

Investing – purchasing land and buildings to open new factories.

Financing – Borrowing from lenders or issuing stock to owners to obtain funds necessary to expand operations.

Question 1-19 (LO 1-3)

Two other important sources of information are the (1) management discussion and analysis of the company’s activities and (2) note disclosures to the financial statements.

Question 1-20 (LO 1-4)

Successful companies use their resources efficiently to sell products and services for a profit. Unsuccessful companies either offer lower-quality products and services or do not efficiently keep their costs low. When a company is unprofitable, investors will neither invest in nor lend to the firm. Without these sources of financing, eventually the company will fail. When a company is able to make a profit, investors and creditors are willing to transfer their resources to it, and the company will expand its profitable operations even further. Investors and creditors rely heavily on financial accounting information in making investment and lending decisions.

*Answers to Review Questions (continued)*

Question 1-21 (LO 1-5)

GAAP refers to Generally Accepted Accounting Principles, or the rules of financial accounting. The fact that all companies use the same rules is critical to financial statement users, because it allows them to accurately *compare* financial information among companies when they are making decisions about where to lend or invest their resources.

Question 1-22 (LO 1-5)

The Financial Accounting Standards Board (FASB) is primarily responsible for the establishment of GAAP in the United States. The International Accounting Standards Board (IASB) serves this function on an international basis.

Question 1-23 (LO 1-5)

U.S. GAAP refers to the set of accounting standards being developed in the United States by the Financial Accounting Standards Board (FASB). IFRS (International Financial Reporting Standards) refers to the set of accounting standards being developed by the International Accounting Standards Board (IASB). The IASB promotes the use of IFRS around the world. Today, the IASB and FASB work closely in an effort to converge the two sets of accounting standards.

Question 1-24 (LO 1-5)

The 1933 Securities Act and the 1934 Securities Exchange Act were designed to restore investor confidence in financial accounting following the stock market crash in 1929 and the ensuing Great Depression. The SEC has the power to require companies with publicly traded securities to prepare periodic financial statements for distribution to investors and creditors.

Question 1-25 (LO 1-5)

The role of auditors is to help ensure that management has in fact appropriately applied GAAP in preparing the company’s financial statements. They are hired by a company as an independent party to express a professional opinion of the conformity of that company’s financial statements with GAAP. Auditors play a major role in investors’ and creditors’ decisions by adding credibility to the financial statements.

Question 1-26 (LO 1-5)

The three objectives of financial reporting are providing information that:

1. is useful to investors and creditors in making decisions.

2. helps to predict cash flows.

3. tells about economic resources, claims to resources, and changes in resources and claims.

*Answers to Review Questions (continued)*

Question 1-27 (LO 1-6)

The benefits to obtaining a degree in accounting include a wide variety of job opportunities, high demand, and high salaries. Public accounting firms are professional service firms that traditionally have focused on three areas: auditing, tax preparation/planning, and business consulting.Private accounting means providing accounting services to the company that employs you. Traditional careers include auditor, tax preparer, consultant, and basic accounting services. Accountants are now expanding into financial analysts, forensic accountants, tax lawyers, FBI agents, and many others.

Question 1-28 (LO 1-7)

*Relevance* and *faithful representation* are the two fundamental qualitative characteristics. Relevance implies that information is useful to the decision at hand. Faithful representation indicates that information accurately represents the underlying activity.

Question 1-29 (LO 1-7)

The three components/aspects of relevance include:

1. Predictive value – Information is useful in helping to forecast future outcomes.

2. Confirmatory value – Information provides feedback on past activities.

3. Materiality – The nature or amount of an item has the ability to affect decisions.

The three components/aspects of faithful representation include:

1. Completeness – All information necessary to describe an item is reported.

2. Verifiability – Measurements that independent parties would agree upon.

3. Free from error – Reported amounts reflect the best available information.

Question 1-30 (LO 1-7)

Cost effectiveness and materiality refer to practical boundaries (constraints) to achieving desired  
qualitative characteristics.Cost effectiveness suggests that financial accounting information is provided only when the benefits of doing so exceed the costs.Materiality reflects the impact of financial accounting information on investors’ and creditors’ decisions. Unless an item is material in amount or nature, it need not be reported in accordance with generally accepted accounting principles.

Question 1-31 (LO 1-7)

The four basic assumptions underlying GAAP include:

1. Economic entity assumption – All economic events can be identified with a particular economic entity.

2. Monetary unit assumption - A common denominator is needed to measure all elements. The dollar in the United States is the most appropriate common denominator to express information about financial statement elements and changes in those elements.

3. Periodicity assumption – The economic life of an enterprise (presumed to be indefinite) can be divided into artificial time periods for financial reporting.

4. Going concern assumption **–** In the absence of information to the contrary, it is anticipated that a business entity will continue to operate indefinitely.

# BRIEF ExErcises

Brief Exercise 1-1 (LO 1-1)

|  |  |
| --- | --- |
| 1. | True |
| 2. | True |
| 3. | False |

Brief Exercise 1-2 (LO 1-2)

|  |  |
| --- | --- |
| 1. | b. |
| 2. | c. |
| 3. | a. |

Brief Exercise 1-3 (LO 1-2)

|  |  |
| --- | --- |
| 1. | c. |
| 2. | a. |
| 3. | b. |

Brief Exercise 1-4 (LO 1-2)

|  |  |
| --- | --- |
| 1. | e. |
| 2. | f. |
| 3. | b. |
| 4. | c. |
| 5. | a. |
| 6. | d. |

Brief Exercise 1-5 (LO 1-2)

|  |  |
| --- | --- |
| 1. | e. |
| 2. | d. |
| 3. | f. |
| 4. | a. |
| 5. | b. |

Brief Exercise 1-6 (LO 1-2)

|  |  |
| --- | --- |
| 1. | b. |
| 2. | a. |
| 3. | e. |
| 4. | c. |
| 5. | d. |

Brief Exercise 1-7 (LO 1-3)

|  |  |
| --- | --- |
| 1. | b. |
| 2. | a. |
| 3. | d. |
| 4. | c. |

Brief Exercise 1-8 (LO 1-3)

|  |  |
| --- | --- |
| 1. | c. |
| 2. | a. |
| 3. | d. |
| 4. | b. |

Brief Exercise 1-9 (LO 1-5)

|  |  |
| --- | --- |
| 1. | b. |
| 2. | d. |
| 3. | a. |
| 4. | c. |

Brief Exercise 1-10 (LO 1-5)

|  |  |
| --- | --- |
| 1. | Yes. |
| 2. | No. |
| 3. | Yes. |
| 4. | No. |
| 5. | Yes. |
| 6. | No. |

Brief Exercise 1-11 (LO 1-6)

|  |  |
| --- | --- |
| 1. | **True** |
| 2. | **True** |
| 3. | **True** |
| 4. | **True** |
| 5. | **True** |
| 6. | **True** |
| 7. | **True** |
| 8. | **True** |
| 9. | **True** |
| 10. | **True** |
| 11. | **True** |
| 12. | **True** |

Brief Exercise 1-12 (LO 1-7)

|  |  |
| --- | --- |
| 1. | b. |
| 2. | a. |
| 3. | c. |

Brief Exercise 1-13 (LO 1-7)

|  |  |
| --- | --- |
| 1. | c. |
| 2. | b. |
| 3. | a. |

# Exercises

Exercise 1-1 (LO 1-2)

|  |  |
| --- | --- |
| 1. | a. |
| 2. | c. |
| 3. | a. |
| 4. | b. |
| 5. | c. |
| 6. | a. |
| 7. | b. |

Exercise 1-2 (LO 1-2)

|  |  |  |
| --- | --- | --- |
| Transaction | Account | Activity |
| 1. Falcon purchases common stock of Wildcat. | Asset | Investing |
| 2. Falcon borrows from Wildcat by signing a note. | Liability | Financing |
| 3. Wildcat pays dividends to Falcon. | Revenue | Operating |
| 4. Falcon provides services to Wildcat. | Revenue | Operating |
| 5. Falcon pays interest to Wildcat on borrowing. | Expense | Operating |

Exercise 1-3 (LO 1-2)

|  |  |  |
| --- | --- | --- |
| Transaction | Account | Activity |
| 1. Falcon purchases common stock of Wildcat. | Equity | Financing |
| 2. Falcon borrows from Wildcat by signing a note. | Asset | Investing |
| 3. Wildcat pays dividends to Falcon. | Dividend | Financing |
| 4. Falcon provides services to Wildcat. | Expense | Operating |
| 5. Falcon pays interest to Wildcat on borrowing. | Revenue | Operating |

Exercise 1-4 (LO 1-2)

Requirement 1

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Revenues | − | Expenses | = | Net Income |
| $14,000 | − | $9,000 | = | $5,000 |

Requirement 2

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Assets | = | Liabilities | + | Stockholders’ equity |
| $50,000 | = | $27,000 | + | $X |
| $50,000 | − | $27,000 | = | $23,000 |

Exercise 1-5 (LO 1-2)

Requirement 1

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Revenues | − | Expenses | = | Net Loss |
| $28,000 | − | $33,000 | = | $5,000 |

Requirement 2

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Assets | = | Liabilities | + | Stockholders’ equity |
| $19,000 | = | $15,000 | + | $X |
| $19,000 | − | $15,000 | = | $4,000 |

Exercise 1-6 (LO 1-3)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Cowboy Law Firm  Income Statement | | | | |
| Service revenue |  |  |  | $9,300 |
| Expenses: |  |  |  |  |
| Salaries |  |  |  | $2,200 |
| Utilities |  |  |  | 1,200 |
| Total expenses |  |  |  | 3,400 |
| Net income |  |  |  | $5,900 |

Exercise 1-7 (LO 1-3)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Buffalo Drilling**  **Statement of Stockholders’ Equity** | | | | | | |
|  | Common  Stock |  | Retained  Earnings |  | Total  Stockholders’  Equity |  |
|  |  |  |  |  |  |  |
| Beginning balance, Jan. 1 | $11,000 |  | $ 8,200 |  | $19,200 |  |
| Issuance of common stock | 8,000 |  |  |  | 8,000 |  |
| Add: Net income |  |  | 8,500 |  | 8,500 |  |
| Less: Dividends |  |  | (3,200) |  | (3,200) |  |
| Ending balance, Dec. 31 | $19,000 |  | $13,500 |  | $32,500 |  |
|  |  |  |  |  |  |  |

Exercise 1-8 (LO 1-3)

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Wolfpack Construction**  **Balance Sheet** | | | | | | | | | | | | | |
| **Assets** | | | | |  | | **Liabilities** | | | | | |  |
| Cash | | | | $ 6,000 |  | | Accounts payable | | | | | $ 3,000 |  |
| Land | | | | 18,000 |  | | Notes payable | | | | | 20,000 |  |
| Equipment | | | | 26,000 |  | | Total liabilities | | | | | 23,000 |  |
|  | | | |  |  | |  | | | | |  |  |
|  | | | |  |  | | **Stockholders’ Equity** | | | | | | |
|  | | | |  |  | | Common stock | | | | | 11,000 |  |
|  | | | |  |  | | Retained earnings | | | | | 16,000 | \* |
|  | | | |  |  | | Total stockholders’ equity | | | | | 27,000 |  |
|  | | | |  |  | | Total liabilities and stockholders’ equity | | | | | $50,000 |  |
| Total assets | | | | $50,000 |  | |
|  | | | |  |  | |  | | | | |  |  |
|  |  |  |  | | |  | |  | | |
| \* | Assets | = | Liabilities | | | + | | Stockholders’ equity | | |
|  | $50,000 | = | $23,000 | | | + | | ($11,000 + Retained earnings) | | |
|  | $50,000 | − | $23,000 | | | − | | $11,000 | = | Retained earnings |
|  |  |  |  | | |  | | $16,000 | = | Retained earnings |

Exercise 1-9 (LO 1-3)

Requirement 1

|  |  |  |  |
| --- | --- | --- | --- |
|  | Beginning balance |  | $ 5,000 |
|  | Cash received from sale of products to customers |  | 40,000 |
|  | Cash received from the bank for long-term loan |  | 45,000 |
|  | Cash paid to purchase factory equipment |  | (50,000) | |
|  | Cash paid to merchandise suppliers |  | (12,000) | |
|  | Cash received from the sale of an unused warehouse |  | 13,000 |
|  | Cash paid to workers |  | (24,000) | |
|  | Cash paid for advertisement |  | (4,000) | |
|  | Cash received for sale of services to customers |  | 30,000 |
|  | Cash paid for dividends to stockholders |  | (6,000) | |
|  | Ending balance |  | **$37,000** |

Requirement 2

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Tiger Trade**  **Statement of Cash Flows** | | | | |
| **Cash Flows from Operating Activities** | |  |  |  |
| Cash inflows: |  |  |  |  |
| From sale of products to customers | $40,000 |  |  |  |
| From sale of services to customers | 30,000 |  |  |  |
| Cash outflows: |  |  |  |  |
| For merchandise suppliers | (12,000) |  |  |  |
| For workers | (24,000) |  |  |  |
| For advertisement | (4,000) |  |  |  |
| Net cash flows from operating activities |  |  | $30,000 |  |
| **Cash Flows from Investing Activities** |  |  |  |  |
| Purchase factory equipment | (50,000) |  |  |  |
| Sale of warehouse | 13,000 |  |  |  |
| Net cash flows from investing activities |  |  | (37,000) |  |
| **Cash Flows from Financing Activities** |  |  |  |  |
| Borrow from bank | 45,000 |  |  |  |
| Pay dividends | (6,000) |  |  |  |
| Net cash flows from financing activities |  |  | 39,000 |  |
| Net increase in cash |  |  | 32,000 |  |
| Cash at the beginning of the year |  |  | 5,000 |  |
| Cash at the end of the year |  |  | $37,000 |  |

Exercise 1-10 (LO 1-3)

Requirement 1

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Fighting Okra Cooking Services  Income Statement | | | | |
| Service revenue |  |  |  | $75,000 |
| Expenses: |  |  |  |  |
| Salaries |  |  |  | $24,000 |
| Supplies |  |  |  | 14,500 |
| Rent |  |  |  | 10,600 |
| Legal fees |  |  |  | 2,400 |
| Postage |  |  |  | 1,500 |
| Total expenses |  |  |  | 53,000 |
| Net income |  |  |  | $22,000 |

Requirement 2

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Fighting Okra Cooking Services**  **Statement of Stockholders’ Equity** | | | | | | |
|  | Common  Stock |  | Retained  Earnings |  | Total  Stockholders’  Equity |  |
|  |  |  |  |  |  |  |
| Beginning balance | $200,000 |  | $32,000 |  | $232,000 |  |
| Issuance of common stock | 25,000 |  |  |  | 25,000 |  |
| Add: Net income |  |  | **22,000** |  | 22,000 |  |
| Less: Dividends |  |  | (10,000) |  | (10,000) |  |
| Ending balance | $225,000 |  | $44,000 |  | $269,000 |  |
|  |  |  |  |  |  |  |

Exercise 1-11 (LO 1-3)

Requirement 1

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Artichoke Academy**  **Statement of Stockholders’ Equity** | | | | | | |
|  | Common  Stock |  | Retained  Earnings |  | Total  Stockholders’  Equity |  |
|  |  |  |  |  |  |  |
| Beginning balance | $150,000 |  | $50,000 |  | $200,000 |  |
| Issuance of common stock | 40,000 |  |  |  | 40,000 |  |
| Add: Net income |  |  | 30,000 |  | 30,000 |  |
| Less: Dividends |  |  | (10,000) |  | (10,000) |  |
| Ending balance | **$190,000** |  | **$70,000** |  | $260,000 |  |
|  |  |  |  |  |  |  |

Requirement 2

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Artichoke Academy**  **Balance Sheet** | | | | | |
| **Assets** | |  | **Liabilities** | |  |
| Cash | $52,600 |  | Accounts payable | $ 9,100 |  |
| Supplies | 13,400 |  | Utilities payable | 2,400 |  |
| Prepaid rent | 24,000 |  | Salaries payable | 3,500 |  |
| Land | 200,000 |  | Notes payable | 15,000 |  |
|  |  |  | Total liabilities | 30,000 |  |
|  |  |  |  |  |  |
|  |  |  | **Stockholders’ Equity** | | |
|  |  |  | Common stock | **190,000** |  |
|  |  |  | Retained earnings | **70,000** |  |
|  |  |  | Total stockholders’ equity | 260,000 |  |
|  |  |  | Total liabilities and stockholders’ equity | $290,000 |  |
| Total assets | $290,000 |  |
|  |  |  |  |  |  |

Exercise 1-12 (LO 1-3)

Requirement 1

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Squirrel Tree Services**  **Balance Sheet** | | | | | |
| **Assets** | |  | **Liabilities** | |  |
| Cash | $ **7,700** |  | Accounts payable | $ 9,700 |  |
| Supplies | 1,800 |  | Salaries payable | 3,500 |  |
| Prepaid insurance | 3,500 |  | Notes payable | 20,000 |  |
| Building | 72,000 |  | Total liabilities | 33,200 |  |
|  |  |  |  |  |  |
|  |  |  | **Stockholders’ Equity** | | |
|  |  |  | Common stock | 40,000 |  |
|  |  |  | Retained earnings | 11,800 |  |
|  |  |  | Total stockholders’ equity | 51,800 |  |
|  |  |  | Total liabilities and stockholders’ equity | $85,000 |  |
| Total assets | $85,000 |  |
|  |  |  |  |  |  |

Requirement 2

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Squirrel Tree Services**  **Statement of Cash Flows** | | | | |
| **Cash Flows from Operating Activities** | |  |  |  |
| Cash inflows from customers | $ 60,000 |  |  |  |
| Cash outflows for salaries | (22,000) |  |  |  |
| Cash outflows for supplies | (4,000) |  |  |  |
| Net cash flows from operating activities |  |  | $34,000 |  |
| **Cash Flows from Investing Activities** |  |  |  |  |
| Sale investments | 10,000 |  |  |  |
| Purchase building | (62,000) |  |  |  |
| Net cash flows from investing activities |  |  | (52,000) |  |
| **Cash Flows from Financing Activities** |  |  |  |  |
| Borrow from bank | 20,000 |  |  |  |
| Pay dividends | (6,500) |  |  |  |
| Net cash flows from financing activities |  |  | 13,500 |  |
| Net decrease in cash |  |  | (4,500) |  |
| Cash at the beginning of the year\* |  |  | 12,200 |  |
| Cash at the end of the year |  |  | $ **7,700** |  |

\* Plug number in order to calculate correct ending balance

Exercise 1-13 (LO 1-3)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 1. | Revenues | − | Expenses | = | Net Income |
|  | $27,000 | − | $18,000 | = | **$9,000** |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 2. | Change in stockholders’ equity | = | Issue common stock | + | Net Income | − | Dividends |
|  | $17,000 | = | $11,000 | + | $12,000 | − | $X |
|  | $17,000 | − | $11,000 | − | $12,000 | = | **$6,000** |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 3. | Assets | = | Liabilities | + | Stockholders’ equity |
|  | $24,000 | = | $X | + | $15,000 |
|  | $24,000 | = | $9,000 | + | $15,000 |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 4. | Total change in cash | = | Operating cash flows | + | Investing cash flows | + | Financing cash flows |
|  | $26,000 | = | $34,000 | + | ($17,000) | + | $X |
|  | $26,000 | − | $34,000 | − | ($17,000) | = | **$9,000** |

Exercise 1-14 (LO 1-3)

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Net  Income | Dividends | Retained Earnings\* |
| 1 | $1,700 | $ 600 | **$ 1,100** |
| 2 | 2,200 | 600 | **2,700** |
| 3 | 3,100 | 1,500 | **4,300** |
| 4 | 4,200 | 1,500 | **7,000** |
| 5 | 5,400 | 1,500 | **10,900** |

\* Retained earnings = Beginning retained earnings + Net income − Dividends

Exercise 1-15 (LO 1-3)

($ in billions)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Change in retained earnings | = | Net income | − | Dividends |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 1. | Change in retained earnings | = | Net income | − | Dividends |
|  | $3.2 | = | $6.9 | − | **$X** |
|  | $3.2 | = | $6.9 | − | **$3.7** |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 2. | Change in retained earnings | = | Net income | − | Dividends |
|  | $3.4 | = | **$X** | − | $2.6 |
|  | $3.4 | = | **$6.0** | − | $2.6 |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 3. | Change in retained earnings | = | Net income | − | Dividends |
|  | $1.6 | = | $1.6 | − | **$X** |
|  | $1.6 | = | $1.6 | − | **$0** |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 4. | Change in retained earnings | = | Net income | − | Dividends |
|  | [$X − (−$1.6)] | = | ($1.0) | − | $0 |
|  | $X = **($2.6)** |  |  |  |  |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 5. | Change in retained earnings | = | Net income | − | Dividends |
|  | [$1.56 − $X] | = | $0.43 | − | $0.06 |
|  | $X = **$1.19** |  |  |  |  |

Exercise 1-16 (LO 1-3)

**($ in billions)**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Assets | = | Liabilities | + | Stockholders’ equity |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 1. | Assets | = | Liabilities | + | Stockholders’ equity |
|  | $228 | = | $107 | + | **$X** |
|  | $228 | = | $107 | + | **$121** |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 2. | Assets | = | Liabilities | + | Stockholders’ equity |
|  | **$X** | = | $1,500 | + | $110 |
|  | **$1,610** | = | $1,500 | + | $110 |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 3. | Assets | = | Liabilities | + | Stockholders’ equity |
|  | $4.7 | = | $X | + | $0.3 |
|  | $4.7 | = | **$4.4** | + | $0.3 |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 4. | Change in assets | = | Change in liabilities | + | Change in stockholders’ equity |
|  | $1.2 | = | $0.3 | + | **$X** |
|  | $1.2 | = | $0.3 | + | **$0.9** |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 5. | Change in assets | = | Change in liabilities | + | Change in stockholders’ equity |
|  | **$X** | = | ($0.34) | + | $0.02 |
|  | **($0.32)** | = | ($0.34) | + | $0.02 |

Exercise 1-17 (LO 1-3)

**($ in billions)**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | Total change in cash | = | Operating cash flows | + | Investing cash flows | + | Financing cash flows |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 1. | Total change in cash | = | Operating cash flows | + | Investing cash flows | + | Financing cash flows |
|  | **$0** | = | $3.6 | + | $0.6 | + | ($4.2) |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 2. | Total change in cash | = | Operating cash flows | + | Investing cash flows | + | Financing cash flows |
|  | ($X − $0.7) | = | $1.4 | + | ($0.3) | + | ($1.4) |
|  | **$X = $0.4** |  |  |  |  |  |  |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 3. | Total change in cash | = | Operating cash flows | + | Investing cash flows | + | Financing cash flows |
|  | $0.04 | = | $0.07 | + | $0.63 | + | **($0.66)** |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 4. | Total change in cash | = | Operating cash flows | + | Investing cash flows | + | Financing cash flows |
|  | $0.02 | = | $0.60 | + | **($1.00)** | + | $0.42 |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 5. | Total change in cash | = | Operating cash flows | + | Investing cash flows | + | Financing cash flows |
|  | $0.02 | = | **$0.41** | + | ($1.42) | + | $1.03 |

Exercise 1-18 (LO 1-5)

|  |  |
| --- | --- |
| 1. | d. |
| 2. | e. |
| 3. | a. |
| 4. | c. |
| 5. | f. |
| 6. | b. |
| 7. | g. |

Exercise 1-19 (LO 1-7)

|  |  |
| --- | --- |
| 1. | **g.** Comparability |
| 2. | **f.** Free from error |
| 3. | **b.** Predictive value |
| 4. | **i.** Timeliness |
| 5. | **a.** Confirmatory value |
| 6. | **e.** Neutrality |
| 7. | **d.** Completeness |
| 8. | **h.** Verifiability |
| 9. | **j.** Understandability |
| 10. | **c.** Materiality |

Exercise 1-20 (LO 1-7)

|  |  |
| --- | --- |
| 1. | b. |
| 2. | c. |
| 3. | d. |
| 4. | a. |

# Problems: Set a

Problem 1-1A (LO 1-2)

|  |  |  |
| --- | --- | --- |
|  | Type of business activity | Transactions |
| 1. | **Financing** | Pay amount owed to the bank for previous borrowing |
| 2. | **Operating** | Pay utility costs |
| 3. | **Investing** | Purchase equipment to be used in operations |
| 4. | **Operating** | Provide services to customers |
| 5. | **Operating** | Purchase office supplies |
| 6. | **Investing** | Purchase a building |
| 7. | **Operating** | Pay workers’ salaries |
| 8. | **Operating** | Pay for research and development costs |
| 9. | **Operating** | Pay taxes to the IRS |
| 10. | **Financing** | Sell common stock to investors |

Problem 1-2A (LO 1-2)

|  |  |  |
| --- | --- | --- |
|  | Account classifications | Account Names |
| 1. | **Stockholders’ equity** | Common stock |
| 2. | **Asset** | Equipment |
| 3. | **Liability** | Salaries payable |
| 4. | **Revenue** | Service revenue |
| 5. | **Expense** | Utilities expense |
| 6. | **Asset** | Supplies |
| 7. | **Expense** | Research and development expense |
| 8. | **Asset** | Land |
| 9. | **Liability** | Income tax payable |
| 10. | **Liability** | Interest payable |

Problem 1-3A (LO 1-3)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Longhorn Corporation  Income Statement | | | | |
| Service revenue |  |  |  | $67,700 |
| Expenses: |  |  |  |  |
| Cost of goods sold |  |  |  | 53,400 |
| Salaries |  |  |  | 5,500 |
| Delivery |  |  |  | 2,600 |
| Total expenses |  |  |  | 61,500 |
| Net income |  |  |  | $ 6,200 |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Longhorn Corporation**  **Statement of Stockholders’ Equity** | | | | | | |
|  | Common  Stock |  | Retained  Earnings |  | Total  Stockholders’  Equity |  |
|  |  |  |  |  |  |  |
| Beginning balance | $40,000 |  | $18,200 |  | $58,200 |  |
| Issuance of common stock | 4,000 |  |  |  | 4,000 |  |
| Add: Net income |  |  | 6,200 |  | 6,200 |  |
| Less: Dividends |  |  | (0) |  | (0) |  |
| Ending balance | $44,000 |  | $24,400 |  | $68,400 |  |
|  |  |  |  |  |  |  |

*Problem 1-3A (concluded)*

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Longhorn Corporation**  **Balance Sheet** | | | | | |
| **Assets** | |  | **Liabilities** | |  |
| Cash | $ 1,200 |  | Accounts payable | $ 4,400 |  |
| Supplies | 3,400 |  | Salaries payable | 800 |  |
| Equipment | 29,000 |  | Total liabilities | 5,200 |  |
| Buildings | 40,000 |  |  |  |  |
|  |  |  | **Stockholders’ Equity** | | |
|  |  |  | Common stock | 44,000 |  |
|  |  |  | Retained earnings | 24,400 |  |
|  |  |  | Total stockholders’ equity | 68,400 |  |
|  |  |  | Total liabilities and stockholders’ equity | $73,600 |  |
| Total assets | $73,600 |  |

Problem 1-4A (LO 1-3)

(Suggested order of calculation)

On the statement of stockholders’ equity,

$7,000 + (c) − $3,000 = $10,000

(c) = **$6,000**

From (c),

(b) = **$6,000**

From (b),

$39,000 − (a) − $6,000 − $4,000 = $6,000 (b)

(a) = **$23,000**

From the statement of stockholders’ equity,

(e) = **$11,100**

(f) = **$10,000**

From total assets,

(g) = **$26,000**

From (e), (f), and (g),

(d) + $11,100 (e) + $10,000 (f) = $26,000 (g)

(d) = **$4,900**

Problem 1-5A (LO 1-3)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Cornhusker Company  Income Statement  For the year ended December 31, 2018 | | | | |
| Service revenues |  |  |  | $37,000 |
| Expenses: |  |  |  |  |
| Rent |  |  |  | 7,000 |
| Utilities |  |  |  | 4,900 |
| Salaries |  |  |  | 13,300 |
| Insurance |  |  |  | 3,500 |
| Total expenses |  |  |  | 28,700 |
| Net income |  |  |  | $ 8,300 |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Cornhusker Company**  **Statement of Stockholders’ Equity**  **For the year ended December 31, 2018** | | | | | | |
|  | Common  Stock |  | Retained  Earnings |  | Total  Stockholders’  Equity |  |
|  |  |  |  |  |  |  |
| Beginning balance (Jan. 1) | $16,000 |  | $7,300 |  | $23,300 |  |
| Issuance of common stock | 0 |  |  |  | 0 |  |
| Add: Net income |  |  | 8,300 |  | 8,300 |  |
| Less: Dividends |  |  | (3,200) |  | (3,200) |  |
| Ending balance (Dec. 31) | $16,000 |  | $12,400 |  | $28,400 |  |
|  |  |  |  |  |  |  |

*Problem 1-5A (concluded)*

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Cornhusker Company**  **Balance Sheet**  **December 31, 2018** | | | | | | |
| **Assets** | | |  | **Liabilities** | |  |
| Cash | $ 4,800 | |  | Accounts payable | $ 2,200 |  |
| Accounts receivable | | 7,200 |  | Salaries payable | 2,400 |  |
| Land | 21,000 | |  | Total liabilities | 4,600 |  |
|  |  | |  |  |  |  |
|  |  | |  | **Stockholders’ Equity** | | |
|  |  | |  | Common stock | 16,000 |  |
|  |  | |  | Retained earnings | 12,400 |  |
|  |  | |  | Total stockholders’ equity | 28,400 |  |
|  |  | |  | Total liabilities and stockholders’ equity | $33,000 |  |
| Total assets | $33,000 | |  |

Problem 1-6A (LO 1-7)

|  |  |
| --- | --- |
|  | Assumption violated |
| 1. | **Going concern** |
| 2. | **Economic entity** |
| 3. | **Monetary unit** |
| 4. | **Periodicity** |

Problem 1-7A (LO 1-7)

|  |  |
| --- | --- |
| 1. | d. |
| 2. | b. |
| 3. | i. |
| 4. | c. |
| 5. | a. |
| 6. | g. |
| 7. | h. |
| 8. | f. |
| 9. | e. |

# Problems: Set B

Problem 1-1B (LO 1-2)

|  |  |  |
| --- | --- | --- |
|  | Type of business activity | Transactions |
| 1. | **Operating** | Pay for advertising |
| 2. | **Financing** | Pay dividends to stockholders |
| 3. | **Operating** | Collect cash from customer for previous sale |
| 4. | **Investing** | Purchase a building to be used for operations |
| 5. | **Investing** | Purchase equipment |
| 6. | **Investing** | Sell land |
| 7. | **Financing** | Receive a loan from the bank by signing a note |
| 8. | **Operating** | Pay suppliers for purchase of supplies |
| 9. | **Operating** | Provide services to customers |
| 10. | **Investing** | Invest in securities of another company |

Problem 1-2B (LO 1-2)

|  |  |  |
| --- | --- | --- |
|  | Account classifications | Account Names |
| 1. | **Asset** | Cash |
| 2. | **Revenue** | Service Revenue |
| 3. | **Asset** | Supplies |
| 4. | **Asset** | Buildings |
| 5. | **Expense** | Advertising Expense |
| 6. | **Asset** | Equipment |
| 7. | **Expense** | Interest Expense |
| 8. | **Liability** | Accounts Payable |
| 9. | **Dividends** | Dividends |
| 10. | **Liability** | Notes Payable |

Problem 1-3B (LO 1-3)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Gator Investments  Income Statement | | | | |
| Service revenue |  |  |  | $127,600 |
| Expenses: |  |  |  |  |
| Advertising |  |  |  | 33,500 |
| Salaries |  |  |  | 65,100 |
| Utilities |  |  |  | 15,500 |
| Interest |  |  |  | 3,500 |
| Total expenses |  |  |  | 117,600 |
| Net income |  |  |  | $ 10,000 |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Gator Investments  **Statement of Stockholders’ Equity** | | | | | | |
|  | Common  Stock |  | Retained  Earnings |  | Total  Stockholders’  Equity |  |
|  |  |  |  |  |  |  |
| Beginning balance | $100,000 |  | $30,300 |  | $130,300 |  |
| Issuance of common stock | 11,000 |  |  |  | 11,000 |  |
| Add: Net income |  |  | 10,000 |  | 10,000 |  |
| Less: Dividends |  |  | (5,200) |  | (5,200) |  |
| Ending balance | $111,000 |  | $35,100 |  | $146,100 |  |
|  |  |  |  |  |  |  |

*Problem 1-3B (concluded)*

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Gator Investments  **Balance Sheet** | | | | | |
| **Assets** | |  | **Liabilities** | |  |
| Cash | $ 5,500 |  | Accounts payable | $ 6,400 |  |
| Equipment | 27,000 |  | Notes payable | 30,000 |  |
| Buildings | 150,000 |  | Total liabilities | 36,400 |  |
|  |  |  |  |  |  |
|  |  |  | **Stockholders’ Equity** | | |
|  |  |  | Common stock | 111,000 |  |
|  |  |  | Retained earnings | 35,100 |  |
|  |  |  | Total stockholders’ equity | 146,100 |  |
|  |  |  | Total liabilities and stockholders’ equity | $182,500 |  |
| Total assets | $182,500 |  |

Problem 1-4B (LO 1-3)

(Suggested order of calculation)

On the statement of stockholders’ equity,

$14,000 + (c) = $17,000

(c) = **$3,000**

$7,000 + $5,000 − (d) = $8,000

(d) = **$4,000**

(b) = **$5,000**

From (b),

(a) − $13,000 − $7,000 − $5,000 = $5,000 (b)

(a) = **$30,000**

From the statement of stockholders’ equity,

(g) = **$17,000**

(h) = **$8,000**

From (g) and (h),

$4,000 + $17,000 (g) + $8,000 (h) = (i)

(i) = **$29,000**

From total liabilities and stockholders’ equity,

(f) = **$29,000**

From (f),

$1,100 + (e) + $6,000 + $16,000 = $29,000 (f)

(e) = **$5,900**

Problem 1-5B (LO 1-3)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Tar Heel Corporation  Income Statement  For the year ended December 31, 2018 | | | | |
| Service revenues |  |  |  | $69,400 |
| Expenses: |  |  |  |  |
| Advertising |  |  |  | 10,400 |
| Utilities |  |  |  | 6,000 |
| Salaries |  |  |  | 26,700 |
| Interest |  |  |  | 2,100 |
| Total expenses |  |  |  | 45,200 |
| Net income |  |  |  | $24,200 |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Tar Heel Corporation  **Statement of Stockholders’ Equity**  **For the year ended December 31, 2018** | | | | | | |
|  | Common  Stock |  | Retained  Earnings |  | Total  Stockholders’  Equity |  |
|  |  |  |  |  |  |  |
| Beginning balance | $21,000 |  | $26,800 |  | $47,800 |  |
| Issuance of common stock | 6,000 |  |  |  | 6,000 |  |
| Add: Net income |  |  | 24,200 |  | 24,200 |  |
| Less: Dividends |  |  | **(11,000)** | \* | (11,000) |  |
| Ending balance | $27,000 |  | $40,000 |  | $67,000 |  |
|  |  |  |  |  |  |  |

\* Beginning retained earnings $26,800

+ Net income 24,200

− Dividends ?

= Ending retained earnings $40,000

*Problem 1-5B (concluded)*

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Tar Heel Corporation  **Balance Sheet**  **December 31, 2018** | | | | | | | | |
| **Assets** | | | |  | **Liabilities** | | |  |
| Cash | $ 5,200 | | |  | Accounts payable | $ 7,700 | |  |
| Accounts receivable | | | 13,200 |  | Salaries payable | | 3,300 |  |
| Supplies | | | 4,600 |  | Note payable | | 25,000 |  |
| Building | | 80,000 | |  | Total liabilities | | 36,000 |  |
|  | | |  |  |  | |  |  |
|  | | |  |  | **Stockholders’ Equity** | | | |
|  | | |  |  | Common stock | 27,000 | |  |
|  | | |  |  | Retained earnings | 40,000 | |  |
|  | | |  |  | Total stockholders’ equity | 67,000 | |  |
|  | | |  |  | Total liabilities and stockholders’ equity | $103,000 | |  |
| Total assets | $103,000 | | |  |

Problem 1-6B (LO 1-7)

|  |  |
| --- | --- |
|  | Assumption violated |
| 1. | **Periodicity** |
| 2. | **Monetary unit** |
| 3. | **Going concern** |
| 4. | **Economic entity** |

Problem 1-7B (LO 1-7)

|  |  |
| --- | --- |
| 1. | h. |
| 2. | g. |
| 3. | f. |
| 4. | a. |
| 5. | d. |
| 6. | e. |
| 7. | i. |
| 8. | b. |
| 9. | c. |

# ADDITIONAL perspectiveS

Additional Perspective 1-1

Requirement 1

The three primary forms of business organizations include sole proprietorship, partnership, and corporation. The major advantage of a corporation is limited liability. Stockholders of a corporation are not held personally responsible for the financial obligations of the corporation. Owners of sole proprietorships or partnerships remain personally liable for activities of the business. Corporations have the disadvantages of double taxation and generally higher tax rates compared to sole proprietorships and partnerships. Because of the higher risk of personal injury due to outdoor adventure activities, it is recommended that Great Adventures be organized as a corporation.

Requirement 2

Typical financing activities include issuing common stock, borrowing, and repayment of borrowing. Typical investing activities include the purchase of long-term assets such as land, buildings, equipment, vehicles, and machinery. Typical operating activities include providing services and products to customers and the associated costs of running the business such as advertising, rent, insurance, wages, and taxes.

Requirement 3

Assets – cash, accounts receivable, supplies, and equipment.

Liabilities – accounts payable, salaries payable, and notes payable.

Stockholders’ equity – common stock and retained earnings.

Revenues – service revenue.

Expenses – advertising, salaries, insurance, and supplies.

Requirement 4

Income statement – revenues less expenses equal net income during an interval of time.

Statement of stockholders’ equity – changes in common stock and retained earnings during an interval of time.

Balance sheet – assets equal liabilities plus stockholders’ equity at a point in time.

Statement of cash flows – cash inflows and outflows related to operating, investing, and financing activities during an interval of time.

Additional Perspective 1-2

**Requirement 1**

Total assets = $1,696,908 ($ in thousands)

Total liabilities = $557,162

Stockholders’ equity = $1,139,746

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Assets | = | Liabilities | + | Stockholders’ Equity |
| $1,696,908 | = | $557,162 | + | $1,139,746 |

**Requirement 2**

Consolidated Statements of Operations

**Requirement 3**

Net sales = $3,282,867 ($ in thousands)

Net income = $80,322

**Requirement 4**

|  |  |  |
| --- | --- | --- |
|  | Inflows | Outflows |
| Investing activities | Sale of available-for-sale securities | Capital expenditures for property and equipment |
| Financing activities | Net proceeds from stock options exercised | Cash dividends paid |

**Requirement 5**

The company’s auditor is Ernst & Young LLP. The auditor states, “In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of American Eagle Outfitters, Inc. at January 31, 2015 and February 1, 2014, and the consolidated results of their operations and their cash flows for each of the three fiscal years in the period ended January 31, 2015, in conformity with U.S. generally accepted accounting principles.”

Additional Perspective 1-3

**Requirement 1**

Total assets = $542,993 ($ in thousands)

Total liabilities = $187,715

Stockholders’ equity = $355,278

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Assets | = | Liabilities | + | Stockholders’ Equity |
| $542,993 | = | $187,715 | + | $355,278 |

**Requirement 2**

Statements of Income

**Requirement 3**

Net sales = $1,153,142 ($ in thousands)

Net income = $162,564

**Requirement 4**

|  |  |  |
| --- | --- | --- |
|  | Inflows | Outflows |
| Investing activities | Proceeds from sales/maturities of investments | Purchases of property and equipment |
| Financing activities | Excess tax benefit from stock option exercises | Payment of dividends |

**Requirement 5**

The company’s auditor is Deloitte & Touche LLP. The auditor states, “In our opinion, such financial statements present fairly, in all material respects, the financial position of The Buckle, Inc. as of January 31, 2015 and February 1, 2014, and the results of its operations and its cash flows for each of the three fiscal years in the period ended February 1, 2014, in conformity with accounting principles generally accepted in the

United States of America.”

Additional Perspective 1-4

**Requirement 1**

The total assets of American Eagle are higher than the total assets of Buckle.

**Requirement 2**

The total liabilities of American Eagle are higher than the total liabilities of Buckle. A higher amount of liabilities does not necessarily mean a higher chance of bankruptcy. The probability of bankruptcy relates to the ability of a company to repay its liabilities as they become due. If sufficient resources are available, then high levels of debt can be paid.

**Requirement 3**

The ratio of total liabilities to total assets can be used as one measure of a company’s ability to repay its liabilities. The higher the ratio, the more difficult it will be for a company to pay its liabilities.

**Requirement 4**

The net income of Buckle is higher than the net income of American Eagle. When one company has a higher net income than another company does, this does not always mean the company’s operations are more profitable. One company may be larger than another company so it has higher net income because operations are larger, but it may be making less profit per dollar of invested assets.

**Requirement 5**

Net income provides a measure of a company’s ability to generate profit for its owners. In the case of American Eagle and Buckle, the owners are the stockholders of the company. An increase in net income is a desirable characteristic of a company that, along with other factors, increases the value (or stock price) of the company to its owners.

Additional Perspective 1-5

It is the responsibility of auditors to act independently of a company when providing a professional opinion as to the conformity of the company’s financial statements with GAAP. An auditor’s ethics might be challenged because of the need to retain the client as a source of revenue. In this case, the auditor might fear losing the $1,000,000 audit fee if it upsets the client by requiring a correction to the financial statements because of questionable accounting practices. The company may fire the auditor and retain the services of someone else.

This problem is further worsened by the company offering an additional $700,000 in client revenue for consulting and tax preparation services. If the auditor upsets the client, the auditor faces the possibility of losing a total of $1,700,000. Would you “look the other way” for $1,700,000?

Additional Perspective 1-6

**Requirement 1**

The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

The SEC was created to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing.

The Securities Act of 1933 has two basic objectives:

* require that investors receive financial and other significant information concerning securities being offered for public sale; and
* prohibit deceit, misrepresentations, and other fraud in the sale of securities.

### The Securities Exchange Act of 1934 created the Securities and Exchange Commission. The Act empowers the SEC to require periodic reporting of information by companies with publicly traded securities.

*Additional Perspective 1-6 (continued)*

**Requirement 2**

The four main financial statements discussed by the SEC are: (1) balance sheets; (2) income statements; (3) cash flow statements; and (4) statements of shareholders’ equity.

A balance sheet provides detailed information about a company’s assets, liabilities and shareholders’ equity.

An income statement is a report that shows how much revenue a company earned over a specific time period (usually for a year or some portion of a year). An income statement also shows the costs and expenses associated with earning that revenue. The literal “bottom line” of the statement usually shows the company’s net earnings or losses. This tells you how much the company earned or lost over the period.

Cash flow statements report a company’s inflows and outflows of cash from three types of activities: (1) operating activities; (2) investing activities; and (3) financing activities.

The statement of shareholders’ equity shows changes in the interests of the company’s shareholders over time.

The disclosure notes provide additional information beyond that reported in the financial statements. This information includes items such as significant accounting policies and practices, income taxes, pension and other retirement plans, stock options, and much more.

MD&A is management’s opportunity to provide investors with its view of the financial performance and condition of the company. It’s management’s opportunity to tell investors what the financial statements show and do not show, as well as important trends and risks that have shaped the past or are reasonably likely to shape the company’s future.

*Additional Perspective 1-6 (concluded)*

**Requirement 3**

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission’s policy has been to rely on the private sector (like the FASB) for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

**Requirement 4**

(a) Yes; Nike properly prepared the four financial statements.

(b) NIKE designs, develops, markets, and sells athletic footwear, apparel,

equipment, accessories, and services worldwide.

(c) In the segment disclosure note, the company reports amounts for items such as revenue, depreciation, net income, accounts receivable, inventories and capital expenditures for each segment.

Additional Perspective 1-7

The functions of financial accounting are to measure business activities of a company and to communicate information about those activities to investors and creditors and other outside users for decision-making purposes.

The four financial statements include:

1. Income statement, which shows revenues and expenses during the reporting period.

2. Statement of stockholders’ equity, which shows the change in stockholders’ equity during the reporting period.

3. Balance sheet, which shows a company’s resources (assets), creditors’ claims to those assets (liabilities), and the remaining claims of stockholders’ to those assets (stockholders’ equity) at the end of the period.

4. Statement of cash flows, which shows a company’s inflows and outflows of cash arising from operating, investing, and financing activities during the reporting period.

The role of auditors is to help ensure that management has in fact appropriately applied Generally Accepted Accounting Principles in preparing the company’s financial statements. Auditors are trained individuals hired by a company as an independent party to express a professional opinion of that company’s financial statements.