CHAPTER 1

Introduction to Financial Statements

Learning Objectives

1. Identify the forms of business organization and the uses of accounting information.

2. Explain the three principal types of business activity.

3. Describe the four financial statements and how they are prepared.

\*4. Explain the career opportunities in accounting.

ANSWERS TO QUESTIONS

**1.** The three basic forms of business organizations are (1) sole proprietorship, (2) partnership, and (3) corporation.

LO 1 BT: K Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA BC: Governance Perspective

**2.** Advantages of a corporation are limited liability (stockholders not being personally liable for cor­porate debts), easy transferability of ownership, and ease of raising funds. Disadvantages of a corporation are increased taxation and government regulations.

LO 1 BT: K Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA BC: Governance Perspective

**3.** Proprietorships and partnerships receive favorable tax treatment compared to corporations and are easier to form than corporations. They are also owner controlled. Disadvantages of proprietorships and partnerships are unlimited liability (proprietors/partners are personally liable for all debts) and difficulty in obtaining financing compared to corporations.

LO 1 BT: K Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA BC: Governance Perspective

4. Yes. Companies can choose one of the hybrid business forms, limited liability corporations (LLCs) or subchapter S corporations, which combine the tax advantages of partnerships with the limited liability of corporations.

LO 1 BT: K Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA BC: Governance Perspective

**5.** Yes. A person cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Accounting provides financial information to interested users through the preparation and distribution of financial statements.

LO 1 BT: C Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

**6.** Internal users are managers who plan, organize, and run a business. To assist management,  
accounting provides timely internal reports. Examples include financial comparisons of operating alternatives, projections of income from new sales campaigns, forecasts of cash needs for the next year, and financial statements.

LO 1 BT: C Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

**7.** External users are those outside the business who have either a present or potential direct   
financial interest (investors and creditors) or an indirect financial interest (taxing authorities, regu­latory agencies, labor unions, customers, and economic planners).

LO 1 BT: C Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

8. The four most common types of data analytics and the basic question each addresses are: Descriptive (What happened?), Diagnostic (Why did it happen?), Predictive (What is likely to happen?), and Prescriptive (What should we do about it?).

LO 1 BT: K Difficulty: E TOT: 2 min. AACSB: nowledge AICPA AC: Measurement Analysis and Interpretation

**Questions Chapter 1 (Continued)**

**9.** The three types of business activities are financing activities, investing activities, and operating activities. Financing activities include borrowing money and selling shares of stock. Investing activities include the purchase and sale of property, plant, and equipment. Operating activities include selling goods, performing services, and purchasing inventory.

LO 2 BT: C Difficulty: M TOT: 2 min. AACSB: Knowledge AICPA AC: Reporting

**10.** (a) Income statement. (d) Balance sheet.

(b) Balance sheet. (e) Balance sheet.

(c) Income statement. (f) Balance sheet.

LO 3 BT: K Difficulty: M TOT: 2 min. AACSB: Knowledge AICPA AC: Reporting

**11.** When a company pays dividends, it reduces the amount of assets available to pay creditors. Therefore, banks and other creditors monitor dividend payments to ensure they do not put a company’s ability to make debt payments at risk.

LO 3 BT: C Difficulty: M TOT: 2 min. AACSB: Knowledge AICPA AC: Measurement Anallysis and Interpretation

**12.** Yes. Net income does appear on the income statement—it is the result of subtracting expenses from revenues. In addition, net income appears in the retained earnings statement—it is shown as an addition to the beginning-of-period retained earnings. Indirectly, the net income of a company is also included in the balance sheet. It is included in the retained earnings account which appears in the stockholders’ equity section of the balance sheet.

LO 3 BT: C Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

**13.** The primary purpose of the statement of cash flows is to provide financial information about the cash receipts and cash payments of a business for a specific period of time.

LO 3 BT: K Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

**14.** The three categories of the statement of cash flows are operating activities, investing activities, and financing activities. The categories were chosen because they represent the three principal types of business activities.

LO 3 BT: C Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

**15.** Retained earnings is the net income retained in a corporation. Retained earnings is increased by net income and is decreased by dividends and a net loss.

LO 3 BT: C Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

**16.** The basic accounting equation is Assets = Liabilities + Stockholders’ Equity.

LO 3 BT: K Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

**Questions Chapter 1 (Continued)**

**17.** (a) Assets are resources owned by a business. Liabilities are amounts owed to creditors. Put more simply, liabilities are existing debts and obligations. Stockholders’ equity is the ownership claim on net assets.

(b) The items that affect stockholders’ equity are issuance of common stock and the components of retained earnings (dividends, revenues, and expenses).

LO 3 BT: K Difficulty: E TOT: 2 min. AACSB: Knowledge AICPA AC: Reporting

**18.** The liabilities are (b) Accounts payable and (g) Salaries and wages payable.

LO 3 BT: C Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

**19.** (a) Net income from the income statement is reported as an increase to retained earnings on the retained earnings statement.

(b) The ending amount on the retained earnings statement is reported as the retained earnings amount on the balance sheet.

(c) The ending amount on the statement of cash flows is reported as the cash amount on the balance sheet.

LO 3 BT: C Difficulty: M TOT: 2 min. AACSB: Knowledge AICPA AC: Reporting

**20.** The purpose of the management discussion and analysis section is to provide management’s views on its ability to pay short-term obligations, its ability to fund operations and expansion, and its results of operations. The MD&A section is a required part of the annual report.

LO 3 BT: K Difficulty: E TOT: 1 min. AACSB: Knowledge AICPA AC: Reporting

**21.** An unqualified opinion shows that, in the opinion of an independent auditor, the financial state­ments have been presented fairly, in conformity with generally accepted accounting principles. This gives investors more confidence that they can rely on the figures reported in the financial statements.

LO 3 BT: C Difficulty: E TOT: 2 min. AACSB: Knowledge AICPA AC: Reporting

**22.** Information included in the notes to the financial statements clarifies information presented in the financial statements and includes descriptions of accounting policies, explanations of uncertain­ties and contingencies, and statistics and details too voluminous to be reported in the financial statements.

LO 3 BT: K Difficulty: E TOT: 1 min. AACSB: None AICPA FC: Reporting

**23.** Using dollar amounts, Apple’s accounting equation (in millions) is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Assets | = | Liabilities | + | Stockholders’ Equity |
| $323,,888 | $258,549 | $65,339 |

LO 3 BT: AP Difficulty: E TOT: 2 min. AACSB: Analytic AICPA AC: Reporting

**Questions Chapter 1 (Continued)**

**24.** A critical audit matter is an audit issue that was material in size and that involved challenging, subjective, or complex auditor judgement.

LO 3 BT: K Difficulty: E TOT: 2 min. AACSB: Knowledge AICPA AC: Research

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 1.1

(a) P Shared control, tax advantages, increased skills and resources.

(b) SP Simple to set up and maintains control with owner.

(c) C Easier to transfer ownership and raise funds, no personal liability.

**LO 1 BT: K Difficulty: Easy TOT: 2 min. AACSB: Knowledge AICPA BC: Governance Perspective**

BRIEF EXERCISE 1.2

(a) 4 Investors in common stock

(b) 3 Marketing managers

(c) 2 Creditors

(d) 5 Chief Financial Officer

(e) 1 Internal Revenue Service

**LO 1 BT: K Difficulty: Easy TOT: 2 min. AACSB: Knowledge AICPA AC: Measurement Analysis and Interpretation**

BRIEF EXERCISE 1.3

O (a) Cash received from customers.

F (b) Cash paid to stockholders (dividends).

F (c) Cash received from issuing new common stock.

O (d) Cash paid to suppliers.

I (e) Cash paid to purchase a new office building.

**LO 2 BT: K Difficulty: Easy TOT: 2 min. AACSB: Knowledge AICPA AC: Measurement Analysis and Interpretation & Reporting**

BRIEF EXERCISE 1.4

E (a) Advertising expense

R (b) Service revenue

E (c) Insurance expense

E (d) Salaries and wages expense

D (e) Cash distributed to stockholders.

R (f) Rent revenue

E (g) Utilities expense

NSE (h) Cash purchase of equipment

C (i) Cash received from investors.

**LO 3 BT: C Difficulty: Easy TOT: 3 min. AACSB: Knowledge AICPA** A**C: Measurement Analysis and Interpretation & Reporting**

BRIEF EXERCISE 1.5

KAROL COMPANY

Balance Sheet

December 31, 2025

Assets

Cash $22,000

Accounts receivable  71,000

Total assets $93,000

Liabilities and Stockholders’ Equity

Liabilities

Accounts payable $65,000

Stockholders’ equity

Common stock $18,000

Retained earnings  10,000

Total stockholders’ equity  28,000

Total liabilities and stockholders’ equity $93,000

**LO 3 BT: AP Difficulty: Medium TOT: 4 min. AACSB: Analytic AICPA AC: Reporting**

BRIEF EXERCISE 1.6

IS (a) Income tax expense

BS (b) Inventory

BS (c) Accounts payable

BS (d) Retained earnings

BS (e) Equipment

IS (f) Sales revenue

IS (g) Cost of goods sold

BS (h) Common stock

BS (i) Accounts receivable

IS (j) Interest expense

**LO 3 BT: K Difficulty: Easy TOT: 3 min. AACSB: Knowledge AICPA AC: Reporting**

BRIEF EXERCISE 1.7

IS (a) Revenue during the period.

BS (b) Supplies on hand at the end of the year.

SCF (c) Cash received from issuing new bonds during the period.

BS (d) Total debts outstanding at the end of the period.

**LO 3 BT: K Difficulty: Easy TOT: 2 min. AACSB: Knowledge AICPA AC: Reporting**

BRIEF EXERCISE 1.8

(a) $90,000 + $230,000 = $320,000 (Total assets)

(Liabilities + Stockholders’ equity = Assets)

($90,000 + $230,000 = $320,000)

(b) $170,000 – $80,000 = $90,000 (Total liabilities)

(Assets – Stockholders’ equity = Liabilities)

($170,000 – $80,000 = $90,000)

(c) $800,000 – 0.25($800,000) = $600,000 (Stockholders’ equity)

(Assets – (0.25 × Assets) = Stockholders’ equity)

[$800,000 – (0.25 × $800,000) = $600,000]

**LO 3 BT: AP Difficulty: Medium TOT: 4 min. AACSB: Analytic AICPA: AC: Measurement Analysis and Interpretation**

BRIEF EXERCISE 1.9

(a) ($800,000 + $150,000) – ($500,000 – $80,000) = $530,000

  (Stockholders’ equity)

[(Assets ± Change in assets) – (Liabilities ± Change in liabilities) = Stockholders’ equity]

[($800,000 + $150,000) – ($500,000 – $80,000) = $530,000]

(b) ($500,000 + $100,000) + [($800,000 – $500,000) – $70,000] = $830,000

  (Assets)

[(Liabilities ± Change in liabilities) + (Stockholders’ equity ± Change in stockholders’   
 equity) = Assets]

[($500,000 + $100,000) + [($800,000 – $500,000) – $70,000] = $830,000]

(c) ($800,000 – $80,000) – [($800,000 – $500,000) + $110,000] = $310,000

  (Liabilities)

[(Assets ± Change in assets) – (Stockholders’ equity ± Change in stockholders’   
 equity) = Liabilities]

[($800,000 – $80,000) – [($800,000 – $500,000) + $110,000] = $310,000]

**LO 3 BT: AP Difficulty: Medium TOT: 5 min. AACSB: Analytic AICPA AC: Measurement Analysis and Interpretation**

BRIEF EXERCISE 1.10

A (a) Accounts receivable

L (b) Salaries and wages payable

A (c) Equipment

A (d) Supplies

SE (e) Common stock

L (f) Notes payable

**LO 3 BT: K Difficulty: Easy TOT: 3 min. AACSB: Knowledge AICPA AC: Reporting**

BRIEF EXERCISE 1.11

(d) All of these are required.

**LO 3 BT: K Difficulty: Easy TOT: 2 min. AACSB: Knowledge AICPA AC: Reporting**

SOLUTIONS TO DO IT! EXERCISES

DO IT! 1.1a

**(a) Easier to transfer ownership: corporation**

**(b) Easier to raise funds: corporation**

**(c) More owner control: sole proprietorship**

**(d) Tax advantages: sole proprietorship and partnership**

**(e) No personal legal liability: corporation**

**LO 1 BT: C Difficulty: Easy TOT: 2 min. AACSB: Kowledge AICPA BC: Governance Perspective**

**DO IT! 1.1b**

**\_3\_ (a) Accounting**

**\_5\_ (b) Internal users of financial information**

**\_2\_ (c) Element of Sarbanes-Oxley Act**

**\_1\_ (d) External users of financial information**

**\_4\_ (e) Steps in solving an ethical dilemma**

**LO 1 BT: K Difficulty: Easy TOT: 2 min. AACSB: Knowledge AICPA AC: Reporting**

**DO IT! 1.2**

**(a) Issuance of ownership shares is classified as common stock.**

**(b) Land purchased is classified as an asset.**

**(c) Amounts owed to suppliers are classified as liabilities.**

**(d) Bonds payable are classified as liabilities.**

**(e) Amount recorded from selling a product is classified as revenue.**

**(f) Cost of advertising is classified as expense.**

**LO 2 BT: K Difficulty: Easy TOT: 2 min. AACSB: Knowledge AICPA AC: Reporting**

**DO IT! 1.3a**

**GRAY CORPORATION**

**Income Statement**

**For the Year Ended December 31, 2025**

**Revenues**

**Service revenue $25,000**

**Expenses**

**Rent expense $10,000**

**Advertising expense 4,000**

**Supplies expense     1,700**

**Total expenses   15,700**

**Net income $ 9,300**

**[Serv. rev.– Tot. expenses = Net inc. or (loss)]**

**[$25,000 – ($10,000 + $4,000 + $1,700) = $9,300]**

**GRAY CORPORATION**

**Retained Earnings Statement**

**For the Year Ended December 31, 2025**

**Retained earnings, January 1 $ –0–**

**Add: Net income 9,300**

**9,300**

**Less: Dividends   2,500**

**Retained earnings, December 31 $6,800**

**(Beg. ret. earn. + Net inc. – Div.= End. ret. earn.)**

**($0 + $9,300 – $2,500 = $6,800)**

**DO IT! 1.3a (Continued)**

**GRAY CORPORATION**

**Balance Sheet**

**December 31, 2025**

**Assets**

**Cash $ 3,100**

**Accounts receivable 2,000**

**Supplies 1,900**

**Equipment   26,800**

**Total assets $33,800**

**Liabilities and Stockholders’ Equity**

**Liabilities**

**Notes payable $ 7,000**

**Account payable     5,000**

**Total liabilities $12,000**

**Stockholders’ equity**

**Common stock 15,000**

**Retained earnings  6,800**

**Total stockholders’ equity   21,800**

**Total liabilities and stockholders’ equity $33,800**

**(Assets = Liabl. + SE)**

**[($3,100 + $2,000 + $1,900 + $26,800) = (($7,000 + $5,000) + ($15,000 + $6,800))]**

**LO 3 BT: AP Difficulty: Hard TOT: 10 min. AACSB: Analytic AICPA AC: Reporting**

**DO IT! 1.3b**

**(a) Description of ability to pay near-term obligations: MD&A**

**(b) Unqualified opinion: auditor’s report**

**(c) Details concerning liabilities, too voluminous to be included in the statements: notes to the financial statements**

**(d) Description of favorable and unfavorable trends: MD&A**

**(e) Certified Public Accountant (CPA): auditor’s report**

(f) Descriptions of significant accounting policies: notes to the financial statements

**LO 3 BT: K Difficulty: Easy TOT: 3 min. AACSB: Knowledge AICPA AC: Reporting**

SOLUTIONS TO EXERCISES

EXERCISE 1.1

(a) 8. Auditor’s opinion

(b) 1. Corporation

(c) 6. Common stock

(d) 7. Accounts payable

(e) 3. Accounts receivable

(f) 2. Creditor

(g) 9. Hybrid form of organization

(h) 5. Stockholder

(i) 4. Partnership

**LO 1-3 BT: K Difficulty: Easy TOT: 2 min. AACSB: Knowledge AICPA AC: Measurement Analysis and Interpretation, Reporting**

**EXERCISE 1.2**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | **Sole Proprietorship** | **Partnership** | **Corporation** |
| **1.** | **No personal liability.** | **F** | **F** | **T** |
| **2.** | **Owners pay personal income tax on company income.** | **T** | **T** | **F** |
| **3.** | **Generally the easiest form of organization to raise capital.** | **F** | **F** | **T** |
| **4.** | **Ownership indicated by shares.** | **F** | **F** | **T** |
| **5.** | **Owned by one person.** | **T** | **F** | **F** |
| **6.** | **Limited life.** | **T** | **T** | **F** |
| **7.** | **Usually easiest form of organization to set up.** | **T** | **F** | **F** |

**LO 1 BT: C Difficulty: Medium TIME: 10 min. AACSB: Knowledge AICPA BC: Governance Perspective**

**EXERCISE 1.3**

|  |  |  |
| --- | --- | --- |
|  | **(a) Type of Evaluation** | **(b) Type of User** |
| **Investor** | **5** | **External** |
| **Marketing manager** | **4** | **Internal** |
| **Creditor** | **1** | **External** |
| **Chief financial officer** | **6** | **Internal** |
| **Internal revenue service** | **2** | **External** |
| **Labor union** | **3** | **External** |

**LO 1 BT: C Difficulty: Easy TIME: 5 min. AACSB: Knowledge AICPA AC: Reporting**

EXERCISE 1.4

a. 8 Assets = Liabilities + Stockholders’ Equity.

b. 1 An individual who has met certain criteria and is thus allowed to perform audits of corporations.

c. 4 Payments of cash from a corporation to its stockholders.

d. 9 The cost of assets consumed or services used in the process of generating revenues.

e.10 Amounts owed to creditors in the form of debts and other obligations.

f. 2 A section of the annual report that presents management’s views on the company’s ability to pay near-term obligations, its ability to fund operations and expansion, and its results of operations.

g. 6 The amount by which expenses exceed revenues.

h. 3 The increase in assets or decrease in liabilities resulting from the sale of goods or the performance of services in the normal course of business.

i. 11 Regulations passed by Congress to reduce unethical corporate behavior.

j. 7 A business owned by one person.

k. 5 The owner’s claim to assets.

**LO 1-3 BT: K Difficulty: Easy TOT: 3 min. AACSB: Knowledge AICPA AC: Measurement Analysis and Interpretation, Reporting**

EXERCISE 1.5

(a) Answers will vary.

|  |  |  |  |
| --- | --- | --- | --- |
|  | Financing | Investing | Operating |
| Abitibi-Consolidated Inc. | Sale of stock | Purchase long-term investments | Sale of  newsprint |
| California State University—Northridge Student Union | Borrow money from a bank | Purchase office equipment | Payment of wages and  benefits |
| Oracle Corporation | Sale of bonds | Purchase other companies | Payment of  research  expenses |
| Aquilini Investment Group | Payment of dividends to stockholders | Purchase hockey equipment | Payment for ice rink rentals |
| Grant Thornton LLP | Distribute earnings to partners | Purchase  computers | Bill clients for professional services |
| Southwest Airlines | Sale of stock | Purchase  airplanes | Payment for  jet fuel |

(b) Financing

Sale of stock is common to all corporations. Borrowing from a bank is common to all businesses. Distribution of earnings to partners would only be common to partnerships. Payment of dividends is common to all corporations. Sale of bonds is common to large corporations.

Investing

Purchase and sale of property, plant, and equipment would be common to all businesses—the types of assets would vary according to the type of business and some types of businesses require a larger investment in long-lived assets. A new business or expanding business would be more apt to acquire property, plant, and equipment while a mature or declining business would be more apt to sell it. Purchase of long-term investments and other companies would be common to all businesses.

Operating

The general activities identified would be common to most businesses, although the service or product would differ.

**LO 2 BT: C Difficulty: Medium TOT: 10 min. AACSB: Knowledge AICPA AC: Measurement Analysis and Interpretation, Reporting**

**EXERCISE 1.6**

**1. O**

**2. I**

**3. O**

**4. F**

**5. F**

**6. F**

**7. O**

**8. F**

**LO 2 BT: K Difficulty: Easy TIME: 5 min. AACSB: Knowledge AICPA AC: Reporting**

EXERCISE 1.7

|  |  |
| --- | --- |
| Accounts payable | L |
| Accounts receivable | A |
| Equipment | A |
| Sales revenue | R |
| Service revenue | R |
| Inventory | A |
| Mortgage payable | L |
| Supplies expense | E |
| Rent expense | E |
| Salaries and wages expense | E |

**LO 2, 3 BT: C Difficulty: Easy TOT: 3 min AACSB: Knowledge AICPA AC:, Reporting**

**EXERCISE 1.8**

**1. IS 9. BS**

**2. BS, SCF 10. IS**

**3. SCF 11. IS**

**4. IS 12. SCF**

**5. BS 13. BS**

**6. RE 14. BS**

**7. RE 15. BS**

**8. BS**

**LO 3 BT: K Difficulty: Easy TIME: 10 min. AACSB: Knowledge AICPA AC: Reporting**

EXERCISE 1.9

BENSER CO.

Income Statement

For the Year Ended December 31, 2025

Revenues

Service revenue $58,000

Expenses

Salaries and wages expense $30,000

Rent expense  10,400

Utilities expense   2,400

Advertising expense   1,800

Total expenses  44,600

Net income $13,400

(Serv. rev. – Tot. exp. = Net inc.)

[$58,000 – ($30,000 + $10,400 + $2,400 + $1,800) = $13,400]

BENSER CO.

Retained Earnings Statement

For the Year Ended December 31, 2025

Retained earnings, January 1 $67,000

Add: Net income  13,400

 80,400

Less: Dividends   6,000

Retained earnings, December 31 $74,400

**(Beg. ret. earn. + Net inc. – Div. = End. ret. earn.)**

**($67,000 + $13,400 – $6,000 = $74,400)**

**LO 3 BT: AP Difficulty: Medium TOT: 6 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.10

(a) MERCK AND CO.

Income Statement

For the Year Ended December 31, 2025

(in millions)

Revenues

Sales revenue $38,576.0

Expenses

Cost of goods sold $ 9,018.9

Selling and administrative expenses 8,543.2

Research and development expense 5,845.0

Income tax expense   2,267.6

 Total expenses  25,674.7

Net income $12,901.3

(Sales rev. – Tot. exp. = Net inc.)

[$38,576.0 – ($9,018.9 + $8,543.2 + $5,845.0 + $2,267.6) = $12,901.3]

MERCK AND CO.

Retained Earnings Statement

For the Year Ended December 31, 2025

(in millions)

Retained earnings, January 1 $43,698.8

Add: Net income 12,901.3

56,600.1

Less: Dividends 3,597.7

Retained earnings, December 31 $53,002.4

**(Beg. ret. earn. + Net inc. – Div. = End. ret. earn.)**

**($43,698.8 + $12,901.3 – $3,597.7 = $53,002.4]**

EXERCISE 1.10 (Continued)

(b) The short-term implication would be a decrease in expenses of $2,922.5 ($5,845 × 50%) resulting in a corresponding increase in income (ignoring income taxes). If all other revenues and expenses remain unchanged, decreasing research and development expenses would produce 22.7% more net income ($2,922.5 ÷ $12,901.3).

The long-term implications would be more difficult to quantify but it is safe to predict that a reduction in research and development expenses would probably result in lower sales revenues in the future. Pharma­ceutical companies are usually able to charge higher prices for newly developed products while lower cost generic versions usually replace older products. Decreasing research and development activities will probably mean fewer new products.

The stock market’s initial reaction might be positive since Merck’s net income would increase significantly. Such a reaction would probably be very short-lived as more knowledgeable investors reviewed Merck’s financial statements and discovered the cause of the increase.

**LO 3 BT: AP Difficulty: Hard TOT: 8 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.11

ZHENG INC.

Retained Earnings Statement

For the Year Ended December 31, 2025

Retained earnings, January 1 $130,000

Add: Net income  225,000\*

 355,000

Less: Dividends   65,000

Retained earnings, December 31 $290,000

\*Service revenue $400,000

\*Total expenses  175,000

\*Net income $225,000

(Beg. ret. earn. + Net inc. – Div. = End. ret. earn.)

[$130,000 + ($400,000 – $175,000) – $65,000 = $290,000]

**LO 3 BT: AP Difficulty: Medium TOT: 4 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.12

RANDALL INC.

Balance Sheet

December 31, 2025

Assets

Cash $ 6,250

Accounts receivable  2,400

Inventory   2,840

Supplies 3,760

Equipment (net)   108,200

    Total assets $123,450

EXERCISE 1.12 (Continued)

Liabilities and Stockholders’ Equity

Liabilities

Notes payable $ 31,500

Accounts payable  3,700

Interest payable  580

Salaries and wages payable 745

Unearned service revenue        850

    Total liabilities $37,375

Stockholders’ equity

Common stock 50,700

Retained earnings\*\*   35,375

    Total stockholders’ equity\*    86,075

Total liabilities and stockholders’ equity $123,450

**\*Tot. assets – Total liabl. = Total SE**

**$123,450 – $37,375 = $86,075**

**\*\*Tot. SE – Common stk. = Ret. earn.**

**$86,075 – $50,700 = $35,375**

**LO 3 BT: AP Difficulty: Medium TOT: 6 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.13

(a) Lee Corporation is distributing nearly all of this year’s net income as dividends. This suggests that Lee is not pursuing rapid growth. Companies that have a lot of opportunities for growth pay low dividends.

(b) Steele Corporation is not generating sufficient cash provided by operating activities to fund its investing activities. Instead it generates additional cash through financing activities. This is common for compa­nies in their early years of existence.

**LO 3 BT: AN Difficulty: Medium TOT: 4 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.14

|  |  |  |
| --- | --- | --- |
| (a) | A | Cash |
|  | SE | Retained earnings |
|  | E | Cost of goods sold |
|  | E | Salaries and wages expense |
|  | A | Prepaid insurance |
|  | A | Inventory |
|  | A | Accounts receivable |
|  | R | Sales revenue |
|  | L | Notes payable |
|  | L | Accounts payable |
|  | R | Service revenue |
|  | E | Interest expense |

(b) LONYEAR INC.

Income Statement

For the Year Ended December 31, 2025

Revenues

Sales revenue $584,951

Service revenue       4,806

 Total revenues   $589,757

Expenses

Cost of goods sold 438,458

Salaries and wages expense 115,131

Interest expense       1,882

 Total expenses   555,471

Net income $ 34,286

**[Tot. rev. – Tot. exp. = Net inc.]**

[($584,951 + $4,806) – ($438,458 + $115,131 + $1,882) = $34,286]

**LO 3 BT: AP Difficulty: Medium TOT: 5 min. AACSB: Analytic AICPA AC: Measurement Analysis and Interpretation, Reporting**

EXERCISE 1.15

(a)

E Interest expense A Equipment, net

L Interest payable E Depreciation expense

L Notes payable A Supplies

R Sales revenue SE Common stock

A Cash E Supplies expense

E Salaries and wages expense

(b) FAMILIA INC.

Income Statement

For the Year Ended December 31, 2025

Revenues

Sales revenue $44,300

Expenses

Salaries and wages expense $15,600

Depreciation expense 3,200

Interest expense       2,200

Supplies expense 900

    Total expenses   21,900

Net income .……………………………………. $22,400

**[Tot. rev. – Tot. exp. = Net inc.]**

[$44,300 – ($15,600 + $3,200 + $2,200 + $900) = $22,400]

**LO 3 BT: AP Difficulty: Medium TOT: 10 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.16

First note that the retained earnings statement shows that (b) equals $27,000.

**Accounts payable + Common stock + Retained earnings = Total liabilities and stockholders’ equity**

$5,000 + a + $27,000 = $62,000

a + $32,000 = $62,000

a = $30,000 Common stock

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

$12,000 + e – $5,000 = $27,000

$7,000 + e = $27,000

e = $20,000 Net income

From above, we know that net income (d) equals $20,000.

**Revenues – Cost of goods sold – Salaries and wages expense = Net income**

$85,000 – c – $10,000 = $20,000

$75,000 – c = $20,000

c = $55,000 Cost of goods sold

**LO 3 BT: AN Difficulty: Hard TOT: 7 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.17

(c) $37,000 (given)

(d) $97,000 = ($22,000 + $38,000 + $37,000)

(b) $97,000 (See (d))

(a) $3,000 = ($97,000 – $29,000 – $65,000)

(e) $17,000 = [$53,000 – ($25,000 + $1,000 + $10,000)]

(g) $25,000 (given)

(f) $18,000 = ($37,000 + $6,000 – $25,000)

**LO 3 BT: AN Difficulty: Medium TOT: 10 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.18

(a) Service revenue $132,000

Sales revenue     25,000

Total revenues  $157,000

Expenses  126,000

Net income $ 31,000

**(Tot. rev. – Exp. = Net inc.)**

[($132,000 + $25,000) – $126,000 = $31,000]

(b) OTAY LAKES PARK

Retained Earnings Statement

For the Year Ended December 31, 2025

Retained earnings, January 1 $ 5,000

Add: Net income  31,000

 36,000

Less: Dividends   9,000

Retained earnings, December 31 $27,000

**(Beg. ret. earn. + Net inc. – Div. = End. ret. earn.)**

**($5,000 + $31,000 – $9,000 = $27,000)**

EXERCISE 1.18 (Continued)

OTAY LAKES PARK

Balance Sheet

December 31, 2025

Assets

Cash $  8,500

Supplies    5,500

Equipment  114,000

Total assets $128,000

Liabilities and Stockholders’ Equity

Liabilities

Notes payable $50,000

Accounts payable  11,000

Total liabilities $ 61,000

Stockholders’ equity

Common stock  40,000

Retained earnings  27,000

Total stockholders’ equity   67,000

Total liabilities and stockholders’ equity $128,000

**(Assets = Liabl. + SE)**

**[($8,500 + $5,500 + $114,000) = (($50,000 + $11,000) + ($40,000 + $27,000))]**

(c) The income statement indicates that revenues from the general store were only about 16% ($25,000 ÷ $157,000) of total revenues which tends to support Walt’s opinion. In order to decide if the store is “more trouble than it is worth,” I would need to know the amount of expenses attribut­able to the general store. The income statement reports all expenses in a single category rather than separating them into camping and general store expenses to correspond with revenues. A break down into two categories would help me decide if the general store is generating a profit or loss.

Even if the general store is operating at a loss, I might recommend  
retaining it if campers indicated that the convenience of having a general store on site was an important amenity in selecting a campground.

**LO 3 BT: AP Difficulty: Hard TOT: 10 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.19

(a) SE Retained earnings

E Cost of goods sold

E Selling and administrative expenses

A Cash

L Notes payable

E Interest expense

L Bonds payable

A Inventory

R Sales revenue

L Accounts payable

SE Common stock

E Income tax expense

(b) KELLOGG COMPANY

Income Statement

For the Year Ended December 31, 2025

(in millions)

Revenues

Sales revenue $12,575

Expenses

Cost of goods sold $7,184

Selling and administrative expenses  3,390

Income tax expense    498

Interest expense    295

Total expenses   11,367

Net income $ 1,208

**[Sales rev. – Tot. exp. = Net inc.]**

[$12,575 – ($7,184 + $3,390 + $498 + $295) = $1,208]

**LO 3 BT: AP Difficulty: Medium TOT: 6 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.20

(a) WILLIAMS CORPORATION

Statement of Cash Flows

For the Year Ended December 31, 2025

Cash flows from operating activities

Cash received from customers $ 50,000)

Cash paid to suppliers (16,000)

Net cash provided by operating activities $ 34,000)

Cash flows from investing activities

Cash paid for new equipment (28,000)

Net cash used by investing activities (28,000)

Cash flows from financing activities

Cash received from lenders 20,000

Cash dividends paid (8,000)

Net cash provided by financing activities 12,000

Net increase in cash ) 18,000

Cash at beginning of period   12,000

Cash at end of period $ 30,000

**(Cash flows from oper., invest., and fin. act. = Net change in cash)**

**[($50,000 – $16,000) – $28,000 + ($20,000 – $8,000) = $18,000]**

(b) As a creditor, I would feel reasonably confident that Williams has the ability to repay its lenders. During 2025, Williams generated $34,000 of cash from its operating activities. This amount more than covered its expenditures for new equipment but not both equipment purchases and dividends.

**LO 3 BT: AP Difficulty: Medium TOT: 6 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.21

(a) SOUTHWEST AIRLINES

Statement of Cash Flows

For the Year Ended December 31, 2025

(in millions)

Cash flows from operating activities

Cash received from customers $9,823

Cash paid for goods and services  (6,978)

Net cash provided by operating activities $2,845

Cash flows from investing activities

Cash paid for property and equipment (1,529)

Net cash used by investing activities (1,529)

Cash flows from financing activities

Cash received from issuance of   
     long-term debt 500

Cash received from issuance of   
     common stock 144

Cash paid for repurchase of common stock   (1,001)

Cash paid for repayment of debt   (122)

Cash paid for dividends   (14)

Net cash used by financing activities     (493)

Net increase in cash 823

Cash at beginning of period   1,390

Cash at end of period $2,213

**(Cash flows from oper., invest., and fin. act. = Net change in cash)**

**[($9,823 – $6,978) – $1,529 + ($500 + $144 – $1,001 – $122 – $14) = $823]**

(b) Southwest reported $2,845,000,000 cash from operating activities but spent $1,529,000,000 to invest in new property and equipment. Its cash from operating activities was sufficient to finance its investing activities. Southwest supplemented the cash from operating activities by issuing long-term debt and additional shares of common stock. It used excess cash to repurchase stock, pay down debt, and pay dividends. In total, it generated more cash from operating activities than it paid for investing and financing activities resulting in a net increase in cash for 2025.

**LO 3 BT: AP Difficulty: Hard TOT: 10 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.22

BEESON COMPANY

Balance Sheet

December 31, 2025

Assets

Cash $18,000

Accounts receivable  12,000

Supplies   9,500

Equipment  40,000

Total assets $79,500

Liabilities and Stockholders’ Equity

Liabilities

Accounts payable $16,000

Stockholders’ equity

Common stock $40,000

Retained earnings  23,500\*

Total stockholders’ equity  63,500

Total liabilities and stockholders’ equity $79,500

\*$31,500 – $8,000

**(Assets = Liabl. + SE)**

[($18,000 + $12,000 + $9,500 + $40,000) = ($16,000 + ($40,000 + ($31,500 – $8,000)))]

**LO 3 BT: AP Difficulty: Medium TOT: 5 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.23

All dollars are in millions.

(a) Assets

Cash $ 2,291.1

Accounts receivable  2,883.9

Inventory  2,357.0

Equipment  1,957.7

Buildings   3,759.9

Total assets $13,249.6

Liabilities

Notes payable $  342.9

Accounts payable    2,815.8

Mortgage payable 1,311.5

Income taxes payable   86.3

Total liabilities $ 4,556.5

Stockholders’ Equity

Common stock $ 2,874.2

Retained earnings   5,818.9

Total stockholders’ equity $ 8,693.1

|  |  |  |  |
| --- | --- | --- | --- |
| (b) |  |  |  |
|  |

(c) Nike has relied more heavily on equity than debt to finance its assets. Debt (liabilities) financed 34% of its assets ($4,556.5 ÷ $13,249.6) compared to equity financing of 66% ($8,693.1 ÷ $13,249.6).

**LO 3 BT: AP Difficulty: Medium TOT: 8 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.24

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| (a) |  | Assets | = | Liabilities | + | Stockholders’ Equity |  |
|  | $110,000 | = | $70,000 | + | (a) |
|  |  | (a) | = | $40,000 |  |  |  |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| (b) |  | Assets | = | Liabilities | + | Stockholders’ Equity |  |
|  | (b) | = | $120,000 | + | $60,000 |
|  |  | (b) | = | $180,000 |  |  |  |

(c) Beginning + Revenues – Expenses – Dividends = Ending

Stockholders’ Stockholders’

Equity Equity

$40,000(a) + $215,000 – $165,000 – (c) = $60,000

$ 90,000 – (c) = $60,000

(c) = $30,000

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| --- | --- | --- | --- | --- | --- | --- | --- |
| (d) |  | Assets | = | Liabilities | + | Stockholders’ Equity |  |
|  | $150,000 | = | (d) | + | $70,000 |
|  |  | (d) | = | $80,000 |  |  |  |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| (e) |  | Assets | = | Liabilities | + | Stockholders’ Equity |  |
|  | $180,000 | = | $  55,000 | + | (e) |
|  |  | (e) | = | $125,000 |  |  |  |

(f) Beginning + Revenues – Expenses – Dividends = Ending

Stockholders’ Stockholders’

Equity Equity

$70,000 + (f) – $80,000 – $5,000 = $125,000(e)

(f) = $140,000

**LO 3 BT: AN Difficulty: Hard TOT: 12 min. AACSB: Analytic AICPA AC: Reporting**

EXERCISE 1.25

(a) Financial statements

(b) Auditor’s opinion

(c) Notes to the financial statements

(d) Financial statements

(e) Management discussion and analysis

(f) Not disclosed

**LO 3 BT: K Difficulty: Easy TOT: 3.0 min. AACSB: Knowledge AICPA AC: Reporting**

EXERCISE 1.26

(a)

**L Accounts payable**

**A Accounts receivable**

**A Buildings**

**A Cash**

**SE Common stock**

**A Equipment, net**

**L Income taxes payable**

**A Inventory**

**A Land**

**L Mortgage payable**

**L Notes payable SE Retained earnings**

**A Supplies**

**(b) *Note to instructors*: Students may list the accounts in the following statement in any order within the assets, liabilities, and shareholders’ equity classifications as they have not yet learned how to classify/order accounts.**

**EXERCISE 1.26 (Continued)**

**AVENTURA INC.**

**Balance Sheet**

**November 30, 2025**

**Assets**

**Cash $ 20,000**

**Accounts receivable 19,500**

**Inventory 18,000**

**Supplies 700**

**Land 44,000**

**Buildings 100,000**

**Equipment,, net 30,000**

**Total assets $232,200**

**Liabilities and Stockholders’ Equity**

**Liabilities**

**Accounts payable $ 26,200**

**Income taxes payable 6,000**

**Notes payable 34,000**

**Mortgage payable 97,500**

**Total liabilities $163,700**

**Stockholders’ equity**

**Common stock 20,000**

**Retained earnings 48,500**

**Total stockholders’ equity 68,500**

**Total liabilities and stockholders’ equity $232,200**

(Assets = Liabilities + Stockholders’ equity)

**LO 3 BT: AP Difficulty: Medium TIME: 20 min. AACSB: Analytic AICPA AC: Reporting**

SOLUTIONS TO PROBLEMS

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| PROBLEM 1.1 |

(a) The concern over legal liability would make the corporate form a better choice over a partnership. Also, the corporate form will allow the busi­ness to raise cash more easily, which may be of importance in a rapidly growing industry.

(b) Bob should run his business as a sole proprietor. He has no real need to raise funds, and he doesn’t need the expertise provided by other partners. The sole proprietorship form would provide the easiest form. One should avoid a more complicated form of business unless the characteristics of that form are needed.

(c) The fact that the combined business expects that it will need to raise significant funds in the near future makes the corporate form more desirable in this case.

(d) It is likely that this business would form as a partnership. Its needs for additional funds would probably be minimal in the foreseeable future. Also, the three know each other well and would appear to be con­tributing equally to the firm. Service firms, like consulting businesses, are frequently formed as partnerships.

(e) One way to ensure control would be for Don to form a sole proprietor­ship. However, in order for this business to thrive it will need a substantial investment of funds early. This would suggest the corpo­rate form of business. In order for Don to maintain control over the business he would need to own more than 50 percent of the voting shares of common stock. In order for the business to grow, he may have to be willing to give up some control.

**LO 1 BT: C Difficulty: Medium TOT: 20 min. AACSB: Knowledge AICPA BC: Governance Perspective**

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| PROBLEM 1.2 |

(a) In deciding whether to extend credit for 30 days, The North Face would be most interested in the balance sheet because the balance sheet shows the assets on hand that would be available for settlement of the debt in the near-term.

(b) In purchasing an investment that will be held for an extended period, the investor must try to predict the future performance of Amazon.com. The income statement provides the most useful information for pre­dicting future performance.

(c) In extending a loan for a relatively long period of time, the lender is most interested in the probability that the company will generate sufficient income to meet its interest payments and repay its principal. The lender would therefore be interested in predicting future net income using the income statement. It should be noted, however, that the lender would also be very interested in both the balance sheet and statement of cash flows—the balance sheet because it would show the amount of debt the company had already incurred, as well as assets that could be liquidated to repay the loan. And the company would be interested in the statement of cash flows because it would provide useful information for predicting the company’s ability to generate cash to repay its obligations.

(d) The president would probably be most interested in the statement of cash flows since it shows how much cash the company generates and how that cash is used. The statement of cash flows can be used to predict the company’s future cash-generating ability.

**LO 3 BT: C Difficulty: Medium TOT: 15 min AACSB: Knowledge AICPA AC: Reporting**

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| PROBLEM 1.3 |

(a) ELITE SERVICE CO.

Income Statement

For the Month Ended June 30, 2025

Revenues

Service revenue $7,500

Expenses

Salaries and wages expense $1,400

Supplies expense 1,000

Maintenance and repairs expense    600

Advertising expense    400

Utilities expense    300

Total expenses  3,700

Net income $3,800

(Serv. rev. – Tot. exp. = Net inc.)

[$7,500 – ($1,400 + $1,000 + $600 + $400 + $300) = $3,800]

ELITE SERVICE CO.

Retained Earnings Statement

For the Month Ended June 30, 2025

Retained earnings, June 1 $    0

Add: Net income  3,800

 3,800

Less: Dividends  1,400

Retained earnings, June 30 $2,400

(Beg. ret. earn. – Net inc. – Div. = End. ret. earn.)

($0 + $3,800 – $1,400 = $2,400)PROBLEM 1.3 (Continued)

ELITE SERVICE CO.

Balance Sheet

June 30, 2025

Assets

Cash $ 4,600

Accounts receivable   4,000

Supplies   2,400

Equipment  26,000

Total assets $37,000

Liabilities and Stockholders’ Equity

Liabilities

Notes payable $12,000

Accounts payable     500

Total liabilities $12,500

Stockholders’ equity

Common stock  22,100

Retained earnings   2,400

Total stockholders’ equity  24,500

Total liabilities and stockholders’ equity $37,000

**(Assets = Liabl. + SE)**

**[($4,600 + $4,000 + $2,400 + $26,000) = (($12,000 + $500) + ($22,100 + $2,400))]**

(b) Elite had a very successful first month, earning $3,800 or about 51% of service revenues ($3,800 ÷ $7,500). Its net income represents a little over 17% return on the initial investment ($3,800 ÷ $22,100).

(c) Distributing a dividend after only one month of operations is probably unusual. Most new businesses choose to build up a cash balance to provide for future operating and investing activities or pay down debt. Elite distributed approximately 37% ($1,400 ÷ $3,800) of its first month’s income but it had adequate cash to do so and still showed a significant increase in retained earnings.

**LO 3 BT: AP Difficulty: Hard TOT: 50 min. AACSB: Analytic AICPA AC: Reporting**

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| PROBLEM 1.4 |

REESE INC.

Income Statement

For the Month Ended October 31, 2025

Revenues:

Service revenue $20,920

Expenses:

Salaries and wages expense $2,500

Interest expense 410

Supplies expense 380

Depreciation expense 270

Total expense     3,560

Net Income…………………………………………. $17,360

(Serv. rev. – Tot. exp. = Net inc.)

[$20,920 – ($2,500 + $410 + $380 + $270) = $17,360]

REESE INC.

Retained Earnings Statement

For the Month Ended October 31, 2025

Retained earnings, October 1 $         0

Add: Net income   17,360

Retained earnings, October 31………………………. $17,360

(Beg. ret. earn. + Net inc. = End. ret. earn.)

($0 + $17,360 = $17,360)

PROBLEM 1.4 (Continued)

REESE INC.

Balance Sheet

October 31, 2025

Assets

Cash $ 3,950

Accounts receivable     1,300

Supplies     2,460

Equipment (net) 48,200

Total assets $55,910

Liabilities and Stockholders’ Equity

Liabilities

Bonds payable $21,500

Accounts payable     3,300

Unearned service revenue     4,065

Salaries and wages payable        445

Interest payable        140

Total liabilities $29,450

Stockholders’ Equity

Common stock     9,100

Retained earnings   17,360

Total stockholders’ equity   26,460

Total liabilities and stockholders’ equity $55,910

**(Assets = Liabl. + SE)**

**[($3,950 + $1,300 + $2,460 + $48,200) = (($21,500 + $3,300 + $4,065 + $445 + $140) + ($9,100 + $17,360))]**

**LO 3 BT: AP Difficulty: Medium TOT: 30 min. AACSB: Analytic AICPA AC: Reporting**

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| PROBLEM 1.5 |

(a)

ROJO CORPORATION

Statement of Cash Flows

For the Year Ended December 31, 2025

Cash flows from operating activities

Cash received from customers $132,000)

Cash paid to suppliers (104,000)

Net cash provided by operating activities $28,000)

Cash flows from investing activities

Cash paid to purchase equipment (12,000)

Net cash used by investing activities (12,000)

Cash flows from financing activities

Cash received from issuing common stock 22,000)

Cash dividends paid (7,000)

Net cash provided by financing activities 15,000)

Net increase in cash 31,000)

Cash at beginning of period 9,000

Cash at end of period $40,000

**(Cash flows from oper., invest., and fin. act. = Net change in cash)**

**[($132,000 – $104,000) – $12,000 + ($22,000 – $7,000) = $31,000]**

(b) Rojo Corporation’s operating activities provided $28,000 of cash which was adequate to fund its investing activities $12,000 and make $7,000 of dividend payments.

**LO 3 BT: AP Difficulty: Medium TOT: 30 min. AACSB: Analytic AICPA AC: Reporting**

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| PROBLEM 1.6 |

(a) 1. Since the boat actually belongs to Miko Liu—not to Micado Corporation—it should not be reported on the corporation’s balance sheet. Likewise, the boat loan is a personal loan of Miko’s—not a liability of Micado Corporation.

2. The inventory should be reported at $25,000, the amount paid when it was purchased. Micado Corporation will record $36,000 as revenues when the inventory is sold.

3. The $10,000 receivable is not an asset of Micado Corporation—it is a personal asset of Miko Liu.

(b) MICADO CORPORATION

Balance Sheet

December 31, 2025

Assets

Cash $20,000 \*

Accounts receivable  40,000 \*

Inventory  25,000 \*

Total assets $85,000 \*

Liabilities and Stockholders’ Equity

Liabilities

Notes payable $15,000 \*

Accounts payable  30,000

Total liabilities $45,000 \*

Stockholders’ equity  40,000 \*\*

Total liabilities and stockholders’ equity $85,000 \*

\*\*$50,000 – $10,000

\*\*$85,000 – $45,000 (Total assets minus total liabilities)

**(Assets = Liabl. + SE)**

**[($20,000 + ($50,000 – $10,000) + $25,000) = (($15,000 + $30,000) + ($85,000 – $45,000))]**

**LO 3 BT: AN Difficulty: Medium TOT: 40 min. AACSB: Analytic AICPA AC: Reporting**

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| CC1 CONTINUING CASE: COOKIE CREATIONS |

(a) Natalie has a choice between a sole proprietorship and a corporation. A partnership is not an option since she is the sole owner of the business.

A proprietorship is easier to create and operate because there are no formal procedures involved in creating the proprietorship. However, if she operates the business as a proprietorship she will personally have unlimited liability for the debts of the business. Operating the business as a corporation would limit her liability to her investment in the business. Organizing as a corporation would also allow Natalie to seek investors in her business. Natalie will in all likelihood require the services of a lawyer to incorporate. Costs to incorporate as well as additional ongoing costs to administrate and operate the business as a corporation may be costly. Also, her taxes would be higher if she incorporates (since the net income of the corporation would be taxed and any dividends Natalie receives would also be taxed).

(b) Yes, Natalie will need accounting information to help her operate her business. She will need information concerning her cash balance on a daily or weekly basis to help her determine if she can pay her bills. She will need to know the cost of her services so she can establish her prices. She will need to know revenue and expenses so she can report her net income for personal income tax purposes, on an annual basis. If she borrows money, she will need financial statements so lenders can assess the liquidity, solvency, and profitability of the business. Natalie would also find financial statements useful to better understand her business and identify any financial issues as early as possible. Monthly financial statements would be best because they are more timely, but they are also more work to prepare.

(c) Assets: Cash, Accounts Receivable, Supplies, Equipment, Prepaid   
Insurance

Liabilities: Accounts Payable, Unearned Service Revenue, Notes Payable

Revenue: Service Revenue

Expenses: Advertising Expense, Supplies Expense, Travel Expense, Utilities Expense, Insurance Expense

CC1 (Continued)

(d) Natalie should have a separate bank account. This will make it easier to prepare financial statements for her business. Regardless of the organizational form of the business it will be a separate entity from Natalie and must be accounted for separately.

(e) I recommend that Natalie keep the car as a personal asset and pay for all costs personally. She should keep track of how many miles she drives for business purposes versus personal use and determine the percentage of business use versus personal use. She should keep track of all costs of owning and operating her car including such things as fuel, insurance, registration, and repairs and maintenance. Then she can multiply the percentage of business use by the total cost of owning and operating her car to calculate the amount of expense the business can record for travel.

The business will record this as an expense. Natalie can either reim­burse herself for these business expenses by taking cash out of the business to pay for these costs or she can treat it as an investment in the business.

[Note to instructors: This last question is fairly complex and there are income tax considerations. This suggested solution does not cover all of the issues that should be considered. The intent is just to ensure   
students begin to think about how to deal with a fairly common issue for self-employed people.]

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| --- |
| CT1.1 FINANCIAL REPORTING PROBLEM |

(a) Apple’s total assets at September 26, 2020 were $323,888 million and at September 28, 2019 were $338,516 million.

(b) Apple had $38,016 million of cash and cash equivalents at September 26, 2020.

(c) Apple had accounts payable totaling $42,296 million on September 26, 2020 and $46,236 million on September 28, 2019.

(d) Apple reported net sales in 2020 of $274,515 million, in 2019 of $260,174 million, and in 2018 of $265,595 million.

(e) Apple’s net income increased by $2,155 million from 2019 to 2020, from $55,256 million to $57,411 million.

**LO 3 BT: AN Difficulty: Medium TOT: 5.0 min. AACSB: Analytic AICPA AC: Reporting**

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| CT1.2 COMPARATIVE ANALYSIS PROBLEM |

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| (a) | (amounts in thousands) |  | Columbia Sportswear  Company |  | Under  Armour, Inc. |
|  | 1. Total liabilities  2. Net property, plant and equipment  3. Net cash provided (used) by investing activities.  4. Net income(loss) |  | $1,003,800  $309,792  $(27,171)  $108,013 |  | $3,354,635  $ 658,678  $66,345  $(549,177) |

(b) Columbia is profitable, while Under Armour is not. Under Armour’s net property, plant, and equipment and total liabilities suggest that it is substantially bigger than Columbia. Under Armour’s liabilities are more than three times as big as Columbia’s.

**LO 3 BT: AN Difficulty: Medium TOT: 8.0 min. AACSB: Analytic AICPA AC: Reporting**

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| CT1.3 COMPARATIVE ANALYSIS PROBLEM |

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| **(a)** |  | **(in millions)** |  | **Amazon.com** |  | **Walmart, Inc.** |
|  | **1.** | **Total assets** |  | **$321,195** |  | **$252,496** |
|  | **2.** | **Accounts receivable (net)** |  | **$24,542** |  | **$6,516** |
|  | **3.** | **Net sales** |  | **$215,915** |  | **$555,233** |
|  | **4.** | **Net income (loss)** |  | **$21,331** |  | **$13,510** |

**(b) Amazon’s total assets are a little over 27% greater than Walmart’s, but, Walmart’s net sales are 2.6 times as large as Amazon’s. However, Walmart’s net income is only 63% as big as Amazon’s. It appears that Amazon does a better job controlling its costs than Walmart. So, it appears that Amazon is the bigger company and more profitable.**

**LO 3 BT: AN Difficulty: Medium TOT: 10.0 min AACSB: Analytic AICPA AC: Reporting**

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| CT1.4 INTERPRETING FINANCIAL STATEMENTS |

(a) Creditors lend money to companies with the expectation that they will be repaid at a specified point in time in the future. If a company is generating cash from operations in excess of its investing needs, it is more likely that it will be able to repay its creditors. Not only did Xerox actually have negative cash from operations, but all of the cash it received in order to meet its cash deficiency was from issuing new debt. Both of these facts would be of concern to the company’s creditors, since it would suggest it will be less likely to be able to repay its debts.

(b) As a stockholder, you are interested in the long-term performance of a company and how that translates into its stock price. Often during the early years of a company’s life its cash provided by operations is not sufficient to meet its investment needs, so the company will have to get cash from outside sources. However, in the case of Xerox, the company has operated for many years and has a well-established name brand. The negative cash from operations might suggest operating deficiencies.

(c) The statement of cash flows reports information on a cash basis. An investor cannot get the complete story on the company’s performance and financial position without looking at the income statement and balance sheet. Also, investors would want to look at more than one year’s worth of data. The current year might not be representative of past or future years.

(d) Xerox is a well-known company. It has a past record of paying dividends. Its management probably decided to continue to pay a dividend to demonstrate confidence in the company’s future. They may have felt that by not paying the dividend for the year they would send a negative message to investors. However, by choosing to pay a cash dividend the company obviously weakened its cash position, and decreased its ability to repay its debts.

**LO 3 BT: S Difficulty: Hard TOT: 15.0 min. AACSB: Analytic AICPA AC: Reporting AICPA PC: Decision Making**

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| CT1.5 REAL-WORLD FOCUS |

Answers to this question will differ depending on the companies chosen by the student, and the year. We provide the following solution for Netflix for the year ended December 31, 2018.

(a) During the year ended December 31, 2018, Netflix reported net income of $1,211,242 thousand.

(b) During the year ended December 31, 2018. Netflix reported sales of $15,794,341 thousand.

(c) The “Industry” label on the left side of the Profile site tells us that Netflix is in the CATV systems.

(d) Companies also in this industry would include Directv, Hulu, Dish Network, and Comcast Corporation.

(e) We chose Dish Network. During the year ended December 31, 2018, Dish reported sales of $13,621,302 thousand and net income of $1,575,091 thousand.

**LO 3 BT: AP Difficulty: Medium TOT: 15.0 min. AACSB: Technology AICPA AC: Reporting**

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| CT1.6 REAL-WORLD FOCUS |

(a) The old auditor’s report focused primarily on whether or not a company’s numbers were “fairly presented”.

(b) The new report requires auditors to tell investors about any “critical audit matters” – areas of their audit that were especially challenging or complex or forced them to make tough decisions in evaluating a company’s books.

Examples include: assessing how a company sets aside loan-loss reserves when it introduces a new loan product; evaluation of a company’s estimates; and, evaluation of the valuations used for acquired assets.

(c) The new report requirements will bring the U. S. closer to the U. K. and other European countries where such disclosures in the audit report are already required.

(d) To be disclosed, an item must be material and significant enough to be reported to the company’s audit committee.

**LO 3 BT: S Difficulty: Medium TOT: 15.0 min. AACSB: Technology, Communication AICPA AC: Reporting AICPA PC: Communication**

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| CT1.7 DECISION-MAKING ACROSS THE ORGANIZATION |

(a) The Report of Independent Registered Public Accounting Firm indicates that PricewaterhouseCoopers LLP performed the audit of Johnson & Johnson’s financial statements.

(b) The Consolidated Statements of Operations states that its basic earnings per share were $5.59 for the year ended January 3 2021.

(c) In the Selected Financial Data (Part II, Item 6 and Note to Financial Statements No. 17), shows that customer – international sales was $39,451 ($82,584 – $43,133) million in 2020.

(d) In the Consolidated Income Statement, sales to customers for 2018 was $81,581 million.

(e) The Shareholders’ Equity section of the Consolidated Balance Sheets states that 4,320,000,000 common shares were authorized.

(f) Per the Consolidated Statements of Cash Flows, $3,347 million was spent on additions to property, plant, and equipment.

(g) Note 1 states that building and building equipment depreciation is based on 20–30 years using straight-line depreciation.

(h) Per the Consolidated Statement of Financial Position, inventories were $9,020 million in 2019.

**LO 3 BT: AN Difficulty: Hard TOT: 20 min. AACSB: Analytic AICPA AC: Reporting**

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| CT1.8 COMMUNICATION ACTIVITY |

To: Marci Ling

From: Student

I have received the balance sheet of Samco Company, Inc. as of December 31, 2025. The purpose of a balance sheet is to report a company’s financial position at a point in time. It reports what the company owns (assets) and what it owes (liabilities) and the net amount attributed to owners (equity). A number of items in this balance sheet are not properly reported. They are:

(1) The balance sheet should be dated as of a specific date, not for a period of time. Therefore, it should be stated “December 31, 2025.”

(2) Equipment should be below Supplies on the balance sheet.

(3) Accounts receivable should be shown as an asset and reported between Cash and Supplies on the balance sheet.

(4) Accounts payable should be shown as a liability, not an asset. Therefore, it should be reported in the liability section, after notes payable.

(5) Liabilities and stockholders’ equity should be shown separately on the balance sheet. Common stock, Retained earnings, and Dividends are not liabilities.

(6) Common stock, Retained earnings, and Dividends are part of stock­holders’ equity. The Dividends account is not reported on the balance sheet but is subtracted from beginning Retained earnings to arrive at the ending balance.

A correct balance sheet is as follows:

CT1.8 (Continued)

SAMCO COMPANY, INC.

Balance Sheet

December 31, 2025

Assets

Cash $  9,000

Accounts receivable   6,000

Supplies   1,000

Equipment  18,000

Total assets $34,000

Liabilities and Stockholders’ Equity

Liabilities

Notes payable $10,000

Accounts payable   4,000

Total liabilities  $14,000

Stockholders’ equity

Common stock 12,000

Retained earnings   8,000\*

Total stockholders’ equity  20,000

Total liabilities and stockholders’ equity $34,000

\*Retained earnings $10,000

\*Less: Dividends   2,000

\*Ending retained earnings $ 8,000

**(Assets = Liabl. + SE)**

[($9,000 + $6,000 + $1,000 + $18,000) = (($10,000 + $4,000) + ($12,000 + ($10,000 – $2,000)))]

**LO 3 BT: C Difficulty: Medium TOT: 15.0 min. AACSB: Knowledge AICPA AC: Reporting**

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| CT1.9 ETHICS CASE |

(a) Investors rely on auditors to perform an independent assessment of a company. If the auditor owns stock in that company, he or she might not be able to act in an independent and impartial manner.

(b) There are pros and cons to this argument. On the positive side, it could be argued that as long as a person has no direct relationship with a client company, that person will not influence the findings of the work. However, a counter argument is that an influential partner within a firm, who had an investment in a client that he or she didn’t work on, might be tempted to try to influence the findings of the audit if he or she feared that the findings were going to negatively affect the value of his or her investment.

(c) The fact that four firms have become so big means that prohibiting employees of those accounting firms from buying stock in clients of the firm would bar those employees from investing in roughly 25% of publicly traded companies. Some have argued that such restrictive rules would create undue hardship, and unfairly restrict the investment options of these people. They also argue that in such a large organization it is increasingly unlikely that an individual who does not work on a particular audit will be able to influence the outcome of that audit. As a consequence, rules that focus on restricting investments by those employees actually involved in the audit of a client may be most reasonable and most effective.

(d) Answers to this question will vary. This is a particularly difficult issue since the rule effectively eliminates the individual’s control over their investment portfolio. They did nothing wrong when they bought the shares, but now they are being forced to sell when it is not advantageous.

(e) The management of PricewaterhouseCoopers noted that auditor inde­pendence is vitally important to the audit function. If investors don’t think the auditor is independent of the client they will lose faith in auditing, which would have dire consequences for securities markets. Therefore, it was important that the firm make a bold, unambiguous response to address this problem.

**LO 3 BT: E Difficulty: Hard TOT: 30.0 min. AACSB: Ethics AICPA AC: Reporting AICPA PC: Ethical Conduct**

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| CT1.10 ETHICS CASE |

**Students responses to each topic will vary. The responses presented below include points that should appear, in some way, to each topic.**

**a. Yes, companies, specifically the management, should be held accountable for the accuracy of their communications. In fact, the Sarbanes-Oxley Act, requires that the top management certify the fairness of the information contained in a company’s financial statements.**

**b. The steps taken to ensure that a company’s financial communications are accurate should include:**

**1. Hire managers with the appropriate education and experience.**

**2. Install an accounting information system that will ensure that accounting transactions are recorded and reported accurately.**

**3. Assuming the company being discussed is a corporation, require the Board of Directors have oversight responsibilities of the reporting system.**

**4. Hire a CPA firm to conduct an annual audit of the information contained in the annual financial statements.**

**5. To ensure that interested outside parties receive timely information, issue periodic (quarterly) financial information.**

**c. The comments presented here are based on the following web addresses:** [**https://www.sec.gov/news/press-release/2018-226**](https://www.sec.gov/news/press-release/2018-226)**;** [**https://www.cnbc.com/2019/03/19/tesla-and-elon-musk-lawsuits-overview.html**](https://www.cnbc.com/2019/03/19/tesla-and-elon-musk-lawsuits-overview.html)**;**[**https://www.washingtonpost.com/technology/2020/02/13/tesla-sec/**](https://www.washingtonpost.com/technology/2020/02/13/tesla-sec/)

**A summary of the charges levied against Elon Musk and Tesla and the subsequent settlement include:**

**In 2018, the SEC claimed that Mr. Musk had intentionally tweeted misleading information about Tesla that negatively impacted the stock market. Additionally, the SEC claimed that Tesla failed to have the required disclosure requirements and procedures related to the accuracy of Mr. Musk’s tweets.**

**CT1.10** **(Continued)**

**In 2019, a settlement was reached that required that:**

**Mr. Musk step down as Tesla’s Chairman.**

**Tesla would appoint two new independent directors to the board.**

**Tesla would create a new committee of independent directors with additional controls and procedures to oversee Mr. Musk’s communications.**

**Both Mr. Musk and Tesla would each pay a $20 million penalty that would be used to compensate harmed investors.**

**In 2020, the SEC issued a subpoena for Tesla financial records due to Mr. Musk making another misleading tweet regarding Tesla’s production estimates that was not approved in advance by securities experts.**

**d. If investors and creditors cannot rely on the accuracy of the information contained in company financial statements then capital markets would, at best, be greatly reduced, or, at worst, cease to exist. Without accurate, reliable information, investors and creditors would be unable to assess the risk of investing or lending. As a result, companies seeking cash inflows from investors/creditors to run and grow their operations, would have to rely solely on the owner(s) personal assets. The result would be to reduce the size of company operations, which would affect employment, and result in a stultifying effect on the economy.**

**LO 1 BT: S Difficulty: Hard TOT: 45.0 min. AACSB: Ethics AICPA AC: Reporting AICPA PC: Ethical Conduct**

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| CT1.11 ALL ABOUT YOU |

(a) Answers to the following will vary depending on students’ opinions.

1. This does not represent the hiding of assets, but rather a choice as to the order of use of assets. This would seem to be ethical.

2. This does not represent the hiding of assets, but rather is a change in the nature of assets. Since the expenditure was necessary, although perhaps accelerated, it would seem to be ethical.

3. This represents an intentional attempt to deceive the financial aid office. It would therefore appear to be both unethical and poten­tially illegal.

4. This is a difficult issue. By taking the leave, actual net income would be reduced. The form asks the applicant to report actual net income. However, it is potentially deceptive since you do not intend on taking unpaid absences in the future, thus future income would be higher than reported income.

(b) Companies might want to overstate net income in order to potentially increase the stock price by improving investors’ perceptions of the company. Also, a higher net income would make it easier to receive debt financing. Finally, managers would want a higher net income to increase the size of their bonuses.

(c) Sometimes companies want to report a lower income if they are negotiating with employees. For example, professional sports teams frequently argue that they cannot increase salaries because they aren’t making enough money. This also occurs in negotiations with unions. For tax accounting (as opposed to the financial accounting in this course) companies frequently try to minimize the amount of reported taxable income.

(d) Unfortunately, many times people who are otherwise very ethical will make unethical decisions regarding financial reporting. They might be driven to do this because of greed. Frequently it is because their superiors have put pressure on them to take an unethical action, and they are afraid to not follow directions because they might lose their job. Also, in some instances top managers will tell subordinates that they should be a team player, and do the action because it would help the company, and therefore would help fellow employees.

**LO3 BT: E Difficulty: Hard TOT: 30.0 min. AACSB: Reflective Thinking AICPA AC: Reporting AICPA PC: Decision Making**

CT1.12 FASB CODIFICATION ACTIVITY

**No solution necessary.**

**CT1.13 CONSIDERING PEOPLE, PLANET AND PROFIT**

**(a) The 5 aspirations relate to the company’s goals: (1) sustaining its business, (2) its brands, (3) its people, (4) its community, and (5) the planet.**

**LO 3 BT: AN Difficulty: Medium TOT: 15.0 min. AACSB: Analytic and Technology AICPA AC: Reporting**

Note: The IFRS section is not included in the print textbook. It is included in the eTextbook only.

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| IFRS CONCEPTS AND APPLICATION |

IFRS1.1

The International Accounting Standards Board, IASB, and the Financial Accounting Standards Board, FASB, are two key players in developing inter­national accounting standards. The IASB releases international standards known as International Financial Reporting Standards (IFRS). The FASB releases US standards, referred to as Generally Accepted Accounting Standards or GAAP.

**LO4 BT: C Difficulty: Easy TOT: 5.0 min. AACSB: Diversity AICPA AC: Reporting AICPA BC: Global and Industry Perspectives**

IFRS1.2

A single set of high-quality accounting standards is needed because of increases in multinational corporations, mergers and acquisitions, use of information technology, and international financial markets.

**LO 4 BT: C Difficulty: Easy TOT: 3.0 min. AACSB: Diversity AICPA AC: Reporting AICPA BC: Global and Industry Perspectives**

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| IFRS1.3 INTERNATIONAL FINANCIAL REPORTING PROBLEM |

(a) Mazars; Ernst & Young Audit

(b) 22 avenue Montaigne, Paris, France 75008

(c) The company reports in Euros.

**LO 4 BT: AN Difficulty: Medium TOT: 5.0 min. AACSB: Technology and Diversity AICPA FC: Reporting AICPA BC: Global and Industry Perspectives**