Cornerstones of Financial Accounting (Canadian) 3rd edition Rich Solutions Manual

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CPA Case #1 Solution

T-Bird Ltd. (TBL)

Note: A general format that works well when answering case-style questions for financial reporting is

Issue:
Analysis:
Recommendation:
Impact on the financial statements:

Assessment Opportunity #1
The candidate analyzes the revenue recognition issue.
Demonstrates Financial Reporting

CPA 1.2.1 – Develops or evaluates appropriate accounting policies and procedures
CPA 1.2.2 – Evaluates treatment for routine transactions

Solution: See Chapter 5 material for guidance.
CPA Canada Handbook Guidance Part II – ASPE Section 3400

Issue:
Sarah recognizes revenue after each customer's repair is finished. She also recognizes the revenue when the customers provide the 50% upfront cash for the special jobs. We need to determine when the appropriate time is to recognize revenue.

Analysis:
Revenue should be recognized when the earnings process is complete. This is normally done when

1) the services have been rendered;
2) the amount of revenue can be reliably measured and is not uncertain;
3) payment to the seller is probable.

Services are rendered after each job is completed for the simple day-to-day jobs. The customer would pay for their vehicle being repaired, and the revenue is recognized by Sarah, as you can make a strong argument that the revenue is earned.

For the special jobs that can last for months, it is not exactly clear. You can make an argument that service is completed once TBL restores the vehicle and it is working properly based on what the customer has asked Bill and TBL to do. You can make a strong case to not recognize any revenue until this point (until the job is complete) or you could make an argument that you

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should be able to recognize some revenue as you work on the vehicle on a month-to-month basis. Clearly, the money received as a deposit in advance of any work performed is not revenue, as TBL has not earned this revenue until they actually perform the service.

You could also question point #2 for the special jobs. TBL might not actually know the total costs and, hence, the revenue they will earn until the job is completed. In this case, they should not recognize any revenue until the service/job is completed.

There is no concern with payment, as the customer will want their vehicle back and they have put down a substantial deposit, so the chance of default is unlikely.

Recommendation:
Revenue should be recognized only when performance has been met and the revenue is earned. As such, the revenue that has been incorrectly recorded on the upfront payments by customers for the special jobs should be deferred until the work is completed. If the job will take several months, the revenue should be recognized based on some reasonable basis such as a percentage completed every month or some other reasonable allocation.

The revenue being recorded for the day to day jobs, once the job is completed and the revenue is recognized, is fine as performance has been met.

Impact on the financial statements:
Any revenue that was recorded for which the revenue was not earned should be reduced. You will have a decrease in revenue on the Statement of Earnings, with an increase in unearned or deferred revenue on the Statement of Financial Position.

NA	The candidate does not address this assessment opportunity.
NC	The candidate does not meet the standards of reaching competence.
RC	The candidate attempts to discuss the revenue recognition issue.
C	The candidate discusses the revenue recognition issue. The candidate supports their discussion based on the criteria. The candidate attempts to discuss the impact on the financial statements.
CD	The candidate discusses the revenue recognition issue in depth and recommends an accounting treatment. The candidate discusses the impact on the financial statements.

Assessment Opportunity #2
The candidate analyzes the inventory issue.
Demonstrates Financial Reporting

CPA 1.2.1 – Develops or evaluates appropriate accounting policies and procedures
CPA 1.2.2 – Evaluates treatment for routine transactions

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Solution: See Chapter 6 material for guidance.
CPA Canada Handbook Guidance Part II – ASPE Section 3031

Issue:
TBL bought a significant number of batteries at a good price in the previous year and, to date, they have not been selling as expected. We have to review how the inventory has been accounted for in the financial statements to make sure it is recorded at the correct amount and that no adjustment is needed.

Analysis:
Inventory should be recorded at the lower of cost and net realizable value (LCNRV).

If the net realizable value (NRV) of a company's inventory is lower than its cost, the company reduces the amount recorded for inventory to its NRV.

We have to compare the cost of the batteries to the NRV.

The NRV is the expected selling price less estimated selling costs such as disposal costs.

Given that Bill has indicated that he is now worried that the batteries he bought have not sold as quickly as he thought they would have, and given that he also indicated more customers are using electric or hybrid vehicles, it seems like the demand for these kinds of batteries is dropping and, hence, the price he can charge for them has most likely dropped. Bill did indicate that they still sell, just not at the rate he expected. This tells us that the batteries still have value, but perhaps the NRV is below cost. After all, Bill bought them just one year ago, so it's unlikely the price would drop that significantly, but it is something to look into further. As such, it would appear reasonable that an adjustment will have to be made.

Recommendation:
Write the inventory down to NRV. We do not have enough details in the case to calculate this, but we will have to compare the cost we paid to the NRV and make any necessary adjustments to the inventory account.

Impact on the financial statements:
Inventory will be reduced on the statement of financial position for the decline to NRV, and the statement of earnings will record an expense for the same amount. It could even be booked to cost of goods sold if you assume they have a cost of goods sold account.

Bill was worried about what the bank would say. The bank will want to make sure the value of the inventory is recorded correctly on the statement of financial position, as they might use some of the inventory as collateral.

Note: We are assuming that after comparing the NRV, which is the expected selling price less estimated selling costs, the value will be below cost.

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NA	The candidate does not address this assessment opportunity.
NC	The candidate does not meet the standards of reaching competence.
RC	The candidate attempts to discuss the inventory issue.
C	The candidate discusses the inventory issue. The candidate supports their discussion based on the criteria. The candidate attempts to discuss the impact on the financial statements.
CD	The candidate discusses the inventory issue in depth and recommends an accounting treatment. The candidate discusses the impact on the financial statements.

Assessment Opportunity #3
The candidate analyzes the control issues to safeguard the assets of the company.
Demonstrates Financial Reporting

CPA 4.1.1 – Assesses the entity's risk assessment processes
CPA 4.1.2 – Evaluates the information system, including the related processes

Solution: See Chapter 4 material for guidance

Note that we don't have to necessarily follow the format mentioned above for a question relating to controls.

Bank reconciliations are prepared, but no one looks at them. It's important that they are prepared, but someone should look at them to ensure they are completed correctly. As mentioned, a bank reconciliation is a control relating to the cash account. Without someone reviewing the bank reconciliation, it serves no purpose. Sarah should prepare the bank reconciliation on a monthly basis, and she should have Bill review the bank reconciliation. The firm of RT LLP might also want to discuss these bank reconciliations with TBL. By having these bank reconciliations prepared and reviewed, it gives oversight to the cash account. You do not want to wait until the end of the year to find out something was happening with the cash account and you never noticed it.

Cash on hand—there is a significant risk of fraud by holding so much cash on the premises. As part of a good control relating to cash, the duties should be segregated. In saying this, certain tasks should not be given to just anyone. Giving the cash to an employee to deposit is not a good idea. Money can go missing. It is important in a small business that the owners get involved. The cash should only be deposited by either Bill or Sarah and on a daily basis. This will ensure that the cash is protected.

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Inventory on Job Order Sheet—Bill has to know what items have been used on the jobs. The risk is that if no one tracks this, Bill will have no idea what to charge customers. He might be charging customers less than he could, which would mean he is suffering a loss. He would also have to worry about possible theft because if it isn't tracked, he can never tie it back to what he expected to be on the premises and in the inventory room. It is important that either Bill get an online system to help track this inventory per job (he can get a simple, off-the-shelf system that can be used to track all information per job) or he would have to be sure to confirm with each worker before the job gets charged to the customer what exactly went into the job. Bill might have to oversee each job as well, which is very time consuming. Recommending a system to help track this would greatly benefit TBL.

Bill should do monthly inventory counts and compare his count to what he expects to be on the premises. Any discrepancies can be followed up on.

The online system he gets should be able to also track all inventory TBL has.

All this will ensure that Bill charges correctly for his jobs and make sure inventory is not going missing. If it does, Bill can then address it immediately.

NA	The candidate does not address this assessment opportunity.
NC	The candidate does not meet the standards of reaching competence.
RC	The candidate attempts to discuss the control issues.
C	The candidate discusses the control issues. The candidate supports their discussion by explaining why there are issues and the impact on financial reporting.
CD	The candidate discusses the control issues. The candidate supports their discussion by explaining why there are issues and the impact on financial reporting. The candidate gets depth in the discussion.

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1 FINANCIAL STATEMENTS AND MAKING BUSINESS DECISIONS

DISCUSSION QUESTIONS

1. Accounting is a system for identifying, measuring, recording, and communicating financial information about an organization's activities to permit informed decisions by decision-makers of the information. Bookkeeping is the process—made up of mechanical "steps"—of recording transactions and maintaining accounting records. While bookkeeping is part of accounting, accounting is viewed as the complete information system that communicates the economic activities of a company to interested parties. Accounting is often referred to as the "language of business" because it communicates information about economic activities of a company that help people make decisions.

2. Accounting information is demanded or needed by decision-makers both inside and outside the business to provide information about business activities and finances so that informed decisions can be made. Five groups that create the demand for accounting information and their uses of accounting information are described below.

(1) Managers need accounting information to plan and make decisions about the business (e.g., predicting the consequences of their actions and deciding on which actions to take) and to control its operations (e.g., evaluating the effectiveness of their past decisions).

(2) Employees use accounting information about their employer to aid in planning their careers (e.g., judging the future prospects of the company).

(3) Investors (owners) need accounting information about a business to evaluate the future prospects of a business and to decide where to invest their money.

(4) Creditors (lenders) need accounting information to decide whether or not to lend money or extend credit to a business.

(5) Governments need accounting information about businesses to determine taxes owed by businesses, to implement a variety of regulatory objectives, and to make national economic policy decisions.

3. An accounting entity is a company that has an identity separate from that of its owners and managers and for which accounting records are kept. There are three main forms that accounting entities take: a sole proprietorship, a partnership, and a corporation.

4. A sole proprietorship is a business entity owned by one person. A partnership is a business entity owned jointly by two or more individuals. Proprietorships and partnerships are not legally separate from the personal affairs of the owners. That is, the owners are responsible for the debts of the business. A corporation is a separate legal entity formed by one or more persons called shareholders. A corporation is legally separate from the affairs of its owners, which limits the shareholders' legal responsibility for the debts of the business to the amount that the shareholders invested in the business. Corporate shareholders may pay more taxes

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than owners of sole proprietorships or partnerships. The majority of business in Canada is conducted by corporations.

5. The three main types of business activities are financing activities, investing activities, and operating activities. Financing activities involve obtaining the funds necessary to begin and operate a business. These funds come from either issuing shares or borrowing money. Investing activities involve buying and selling assets that enable a corporation to operate. Operating activities are the normal business activities that a company engages in as it conducts its business. These activities involve selling products or services, purchasing inventory, collecting amounts due from customers, and paying suppliers.

6. Assets are the economic resources or future economic benefits obtained or controlled by a business. Liabilities are the creditors' claims on the resources of a business. Shareholders' equity is the ownership claims on the resources of a business. Shareholders' equity is considered a residual interest in the assets of a business that remain after deducting the business's liabilities. All three items appear on the statement of financial position, forming the following equation:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

7. Revenues are the increases in assets (resources) that result from the sale of products or services. Expenses are the costs of assets (resources) used, or the liabilities created, in the operation of the business. If revenues are greater than expenses, a corporation has earned net income. If expenses are greater than revenues, a corporation has incurred a net loss.

8. The four primary financial statements are:

(1) The statement of financial position: a presentation of information about a company's economic resources (its assets) and the claims against those resources by creditors and owners (liabilities and shareholders' equity) at a specific point in time.

(2) The statement of earnings: a report on how well a company has performed its operations— the profitability of a company—over a period of time.

(3) The statement of retained earnings: a report on how much of the company's income was retained in the business and how much was distributed to owners over a period of time.

(4) The statement of cash flows: a report on the changes in a company's cash during a period of time. The statement of cash flows provides information about the company's cash inflows (sources) and outflows (uses/generated) from operating, investing, and financing activities.

9. There are many questions that can be answered based on each of the financial statements:

(1) The statement of financial position:

a. What is the total amount of assets (economic resources) of a corporation? What is the total amount of liabilities (claims against the resources) for a corporation?

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b. How much equity do the owners of the corporation have in its assets?

c. Is the corporation able to pay its debts as they become due?

(2) The statement of earnings:

a. How much revenue was earned last month? Last quarter? Last year?

b. What was the total amount of expenses incurred to earn that revenue?

c. How much better off is the corporation at the end of the year than it was at the beginning of the year?

d. Was the corporation profitable, and what are the prospects for the corporation's future profitability?

e. What are the prospects for the future growth of the corporation?

(3) The statement of retained earnings:

a. How much income was distributed in dividends by the corporation?

b. What amount of equity in the business has been generated internally?

(4) The statement of cash flows:

a. How much cash was taken in or paid out as a result of operations?

b. How much cash was invested in new equipment?

c. How much cash was used to pay off business debt?

10. Point-in-time measurement means as of a particular date. The statement of financial position is a point-in-time measurement. The period-of-time description applies to what has happened over a time interval. The statement of earnings is a period-of-time measurement that explains the business activities between statement of financial position dates. The statement of cash flows and the statement of retained earnings are also period-of-time measurements.

11. The basic accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

The equation is significant because it means that the statement of financial position must always balance. This implies that what a company owns (its resources) must always be equal to the claims of its creditors (liabilities) and investors (shareholders' equity).

12. Each financial statement includes a heading that is comprised of (a) the name of the company, (b) the title of the financial statement, and (c) the time period covered—either a point-in-time measurement (an exact date) or a period-of-time description (e.g., a year ended on a specific date).

13. Current assets are cash and other assets that are reasonably expected to be converted to cash within one year or the operating cycle, whichever is longer. Current liabilities are obligations that will be satisfied within one year or the operating cycle, whichever is longer.

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Since current assets are presented separately from other assets, statement users can see if the firm is likely to have enough resources available to meet its current liabilities as they come due. If current assets were presented among other assets, such a determination would be difficult.

Current liabilities are separated from long-term liabilities because current liabilities will require asset outflows (or replacement with another liability) much sooner than will long-term liabilities. If all liabilities were presented together, financial statement decision-makers would have difficulty in determining the assets (economic resources) required in the near future to satisfy the current liabilities.

14. Current assets are generally listed on the statement of financial position in order of liquidity or nearness to cash, whereas current liabilities are usually listed in the order in which they will be paid.

15. The two main components of equity are contributed capital and retained earnings. Contributed capital is increased by investments of new capital in a company by its owners (the issue of common shares and preferred shares to shareholders). Retained earnings is the accumulated net income of a company that has not been distributed to owners. Retained earnings is increased by net income and decreased by net losses and dividends.

16. $\text{Net Income} = \text{Total Revenues} - \text{Total Expenses}$

17. The single-step statement of earnings format takes into account only two categories: total revenues and total expenses. Total expenses are subtracted from total revenues in a single step to arrive at net income. The multiple-step statement of earnings format contains three important subtotals: gross margin (gross profit), income from operations, and net income. Gross margin is the difference between net sales and cost of sales (or cost of goods sold). Income from operations is the difference between gross margin and operating expenses. Net income is the difference between income from operations and any nonoperating revenues and expenses.

18. A statement of retained earnings summarizes and explains the changes in retained earnings during an accounting period. Retained earnings is the income earned by the company but not paid to the owners in the form of dividends. The statement of retained earnings starts with the balance in retained earnings at the beginning of the period. To this balance, add net income (or subtract the net loss) obtained from the statement of earnings. Next, subtract any dividends the company declared during the period. The total is the retained earnings at the end of the period that is reported on the statement of financial position.

19. The statement of cash flows classifies cash flows into three categories: (1) cash flows from operating activities, (2) cash flows from investing activities, and (3) cash flows from financing activities. Cash flows from operating activities are the cash flows related to the normal operations of the business in earning income, and include cash sales and collections of accounts receivable less cash paid for goods, services, wages, salaries, and interest. Cash flows from investing activities are cash flows related to the acquisition or sale of investments and long-term assets, including cash received from the sales of property, plant, and equipment; investments; and other long-lived assets less the cash spent to purchase long-term assets. The cash flows from investing activities by a healthy, growing business will usually represent an excess of expenditures over receipts. Cash flows from financing

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activities are the cash flows related to obtaining the capital of the company, including the cash contributed by owners and borrowed from creditors less amounts paid as dividends and repayments of liabilities. A business can finance its growth either internally with cash generated by operations or externally with cash from owners and creditors.

20. The statement of retained earnings describes the changes in retained earnings, a statement of financial position account, that occurs between two statement of financial position dates. One of the major sources of change in retained earnings is the net income (or net loss) for the year, which is determined on the statetment of earnings. The other major source of change in retained earnings is dividends, which are not considered a part of income.

21. Other than the financial statements, decision-makers will find notes to the financial statements, management's discussion and analysis of the condition of the company, and the auditor's report in the annual report of a company. The notes to the financial statements are an integral part of the financial statements that clarify and expand upon the information in the financial statements. Management's discussion and analysis provides a discussion and explanation of various items reported in the financial statements. Additionally, management uses this opportunity to highlight favourable and unfavourable trends and significant risks facing the company. The auditor's report expresses the opinion of the auditor as to whether the financial statements fairly present the financial position and results of operations of the company.

22. Examples of unethical behaviour will differ from one student to another. One example is an accountant who gives in to personal pressure to prepare financial statements that overstate the income of the company by bending or violating accounting standards.

Overstated income may lead decision-makers to make the wrong choices. Decision-makers both inside and outside the business must be able to rely on the financial information they receive to make proper decisions. Therefore, ethical behaviour by accountants is necessary. Acting ethically is not always easy. However, because of the important role of accounting in society, accountants are expected to maintain the highest level of ethical behaviour.

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MULTIPLE-CHOICE EXERCISES

1-1. a

1-2. d

1-3. b

1-4. a ($10,500 – $5,800)

1-5. b

1-6. d

1-7. d

1-8. b ($8,200 + $3,700 + $3,900)

1-9. c ($5,900 + $12,000)

1-10. a

1-11. b ($165,500 – $92,100 – $43,850 – $15,000)

1-12. c

1-13. c

1-14. b

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CORNERSTONE EXERCISES

CE 1-15

Scenario 1:	Assets	=	Liabilities	+	Equity
	X	=	$33,000	+	$44,000
	X	=	$77,000		

Scenario 2:	$110,000	=	X	+	$68,000
	X	=	$42,000		

Scenario 3:	$49,000	=	$32,000	+	X
	X	=	$17,000		

CE 1-16

Note: Be sure to treat situations b. through d. independently.

	Assets	=	Liabilities	+ Equity
	$440,000	=	$285,000	+ X
a.	X	=	$155,000	at the beginning of the year

	Assets	=	Liabilities	+	Equity
b.	$525,000*	=	$323,000**	+	X
	X	=	$202,000		

* $440,000 + $85,000
** $285,000 + $38,000

	Assets	=	Liabilities	+	Equity
c.	$375,000*	=	X	+	$200,000**
	X	=	$175,000		

* $440,000 − $65,000
** $155,000 (from part a) + $45,000

	Assets	=	Liabilities	+	Equity
d.	X	=	$380,000*	+	$80,000**
	X	=	$460,000		

* $285,000 + $95,000
** $155,000 (from part a) − $75,000

CE 1-17

a. statement of financial position (SFP)

b. Statement of cash flows (CF)

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c. statement of financial position (SFP)

d. statement of earnings (SE)

e. Statement of cash flows (CF)

f. statement of earnings (SE)

g. statement of financial position (SFP)

h. statement of retained earnings (RE)

CE 1-18

1. d

2. b

3. a

4. f

5. e

6. a

7. c

8. g (*Note:* While net income and dividends are reported on other financial statements, the definition of retained earnings is income that has not been distributed to shareholders. Therefore, by definition, this item is part of a company's retained earnings.)

9. b

10. a

CE 1-19

Cavernous Homes Ltd.
Statement of Financial Position 31-Dec-22
Assets

Cash……	$3,200	
Accounts receivable……	4,500	
Supplies……	8,100	
Total assets……		$15,800

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Liabilities and Shareholders' Equity

Liabilities:		
Notes payable	$5,000	
Total liabilities		$5,000
Shareholders' equity:		
Common shares	$7,000	
Retained earnings	3,800	
Total shareholders' equity		10,800
Total liabilities and shareholders' equity		$15,800

CE 1-20

$$\begin{array}{lcll} \text{Net Income} & = & \text{Total Revenue} & \text{Total Expenses} \\ \text{Net Income} & = & \$78,000 & (\$33,200 + \$20,500) \\ \text{Net Income} & = & \$24,300 & \end{array}$$

Note: The dividends do not appear on the statement of earnings in arriving at net income. Dividends do not affect the statement of earnings. Dividends are a reduction of the balance in retained earnings.

CE 1-21

Beginning retained earnings	$25,000
+ Net income ($74,000 − $57,000)	$17,000
− Dividends	(8,000)
= Ending retained earnings	$34,000

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BRIEF EXERCISES

BE 1-22

a. Government

b. Manager

c. Creditor

d. Investor

e. Employee

BE 1-23

a. Corporation

b. Sole Proprietorship, Partnership

c. Partnership

d. Corporation

e. Corporation

f. Corporation

g. Corporation

BE 1-24

a. Financing

b. Operating

c. Investing

d. Financing

e. Operating

f. Operating

g. Financing

BE 1-25

a. Total assets $202,000

b. Total liabilities $32,500

c. Increase in shareholders' equity $95,000

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BE 1-26

1. b - PPE
2. c - Intangible assets
3. a - Current assets
4. d - Current liabilities
5. a - Current assets
6. f - Contributed capital
7. d - Current liabilities
8. a - Current assets
9. a - Current assets
10. e - Long-term liabilities

BE 1-27

Rutherford Company
Statement of Earnings
For the Year Ended December 31, 2022

Revenues and gains:		
Sales revenue	$65,000	
Interest income	3,900	
Total revenues		$68,900
Expenses and losses:		
Cost of goods sold	28,800	
Insurance expense	4,300	
Loss on disposal of property, plant, and equipment	1,200	
Total expenses and losses		34,300
Net income		$34,600

BE 1-28

a. I – Increases retained earnings
b. D – Decreases retained earnings
c. I – Increases retained earnings
d. NE – No effect on retained earnings
e. D – Decreases retained earnings

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f. D – Decreases retained earnings

BE 1-29

a. O – Operating activities

b. F – Financing activities

c. F – Financing activities

d. O – Operating activities

e. I – Investing activities

BE 1-30

(a) $55,000

(b) $64,000

(c) $20,000

BE 1-31

1. (a) Notes to the financial statements

2. (c) Report of independent accountants

3. (b) Management's discussion and analysis

4. (a) Notes to the financial statements

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EXERCISES

E 1-32

1. Lenders (Banks) (B)

2. Government (G)

3. Business managers (M)

4. Investor (I)

5. Labour union (U)

E 1-33

1. Sole proprietorship: 1, 2, 4, 5

Partnership: 2, 3, 4, 5, 7

Corporation: 2, 3, 4, 5, 6, 8

2. There are many advantages and disadvantages to each particular type of business entity as listed below.

a. Sole Proprietorship

- Advantages:

(i) The business is easily formed

(ii) Control over the operations of the business is maintained by owner

(iii) Sole proprietorships may pay less tax relative to corporations

- Disadvantages:

(i) The owner is personally liable for the debts of the business

(ii) The life of the business is limited to the owner's life

b. Partnership:

- Advantages:

(i) Increased access to the financial resources and individual skills of each of the partners

(ii) Partnerships may pay less tax relative to corporations

- Disadvantages:

(i) Control over the operations of the business is shared among the partners

(ii) The partners are personally liable for the debts of the business

(iii) The life of the business is limited to life of the partners

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c. Corporation:

- Advantages:

  (i) Can more easily raise large amounts of money

  (ii) Ownership of the business can be easily transferred by selling shares

  (iii) The owners' liability is limited to the amount invested in the business

- Disadvantages:

  (i) The formation and organization of the business is more complex

  (ii) Corporations may pay higher taxes

E 1-34

a. Investing (I)

b. Financing (F)

c. Operating (O)

d. Investing (I)

e. Operating (O)

f. Financing (F)

g. Financing (F)

E 1-35

a. Financing (F)

b. Investing (I)

c. Investing (I)

d. Operating (O)

e. Operating (O)

f. Financing (F)

g. Operating (O)

h. Operating (O)

i. Investing (I)

j. Financing (F)

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E 1-36

1. c

2. e

3. b

4. g

5. d

6. f

7. a

E 1-37

	Assets	=	Liabilities	+	Equity
1.	$275,000		$224,000*		$51,000
2.	75,000		162,500		(87,500)**
3.	58,200 ***		15,000		43,200

* $\$275,000 - \$51,000$

** $\$75,000 - \$162,500$

*** $\$15,000 + \$43,200$

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E 1-38

1.

Huang Company

Statement of Financial Position

Specific Point in Time

Assets

Current assets:

Cash

Accounts receivable

Inventory

Prepaid insurance

Total current assets

Property, plant, and equipment:

Building

Equipment

Less: Accumulated depreciation

Intangible assets:

Trademarks

Total assets

Liabilities and Shareholders' Equity

Liabilities:

Current liabilities:

Accounts payable

Income taxes payable

Wages payable

Total current liabilities

Long-term liabilities:

Notes payable

Bonds payable

Total long-term liabilities

Total liabilities

Shareholders' equity:

Common shares

Retained earnings

Total shareholders' equity

Total liabilities and shareholders' equity

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2. To assess liquidity, it would be helpful to have information on Huang Company's current assets (cash, accounts receivable, inventory, and prepaid insurance) and current liabilities (accounts payable, income taxes payable, and wages payable). With this information, a decision-maker could compute the company's working capital (current assets less current liabilities) and current ratio (current assets ÷ current liabilities). These two measures are helpful in assessing a company's ability to pay its debts as they become due.

E 1-39

1. Since the operating cycle is six months, Dunn would use one year as the breakpoint between current and noncurrent items.

a. There are 17 months of prepaid rent ($8,500 ÷ $500). Dunn should include $6,000 (12 months × $500 per month) as a current asset and $2,500 (the (remaining 5 months × $500 per month) as a long-term asset.

b. The $9,700 is a current liability.

c. Since all items are expected to be sold within 12 months, the entire $46,230 is a current asset.

d. The $700 portion of marketable securities is a current asset. The remaining $1,200 is a long-term investment. Note that the question tells us that the balance of $1,200 is not expected to be sold until 2025, hence, it is considered long-term. If we were not told this, you should show the full $1,900 as current.

e. The $1,050 of cash is a current asset.

f. The $60,000 note due in February 2027 is a long-term liability. The $3,750 interest related to 2022 is a current liability. The remaining interest of $750 will not be recognized until 2023 and, therefore, is not on the 2022 statement of financial position.

g. The entire $2,850 is a current asset.

h. The store equipment and its accumulated depreciation are not current assets. Instead, they are classified as property, plant, and equipment.

Dunn Sporting Goods
Partial Statement of Financial Position
December 31, 2022

Current assets:	
Cash ……	$1,050
Short-term investment in marketable securities ……	700
Accounts receivable……	2,850

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Inventory	46,230	
Prepaid rent	6,000	
Total current assets		$56,830
Current liabilities:		
Accounts payable	$9,700	
Interest payable on equipment loan (see f above)	3,750	
Total current liabilities		$13,450

2.

$$\begin{aligned}\text{Working Capital} &= \text{Current Assets} - \text{Current Liabilities}\\ &= \$56,860 - \$13,450\\ &= \$43,380\end{aligned}$$

$$\begin{aligned}\text{Current Ratio} &= \text{Current Assets} \div \text{Current Liabilities}\\ &= \$56,860 \div \$13,450\\ &= 4.23\end{aligned}$$

3. These ratios give users insights into a company's liquidity—that is, a company's ability to pay its obligations as they become due. These ratios show that Dunn Sporting Goods has adequate current assets to cover all of the current liabilities that will become due in the near future. Comparing these ratios to other companies in the same industry and examining the trend in these measures over time will yield additional insights.

E 1-40

1.

Hanson Construction
Partial Statement of Financial Position
December 31, 2022

Current assets:	
Cash	$475
Accounts receivable	8,000
Note receivable	1,200
Supplies	8,800
Total current assets	$18,475
Current liabilities:	
Accounts payable	$1,800
Notes payable	7,600
Total current liabilities	$9,400

The accounts receivable of $4,000 due in 18 months will be classified as a long- term asset. The construction equipment and related accumulated depreciation are classified as property, plant, and equipment (a noncurrent asset).

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2. Hanson Construction's liquidity may be evaluated by examining its current ratio and working capital. Its current ratio is $1.97 (\$18,475 \div \$9,400)$ and its working capital is $\$9,075 (\$18,475 - \$9,400)$. Because current assets well exceed the current liabilities, Hanson appears to be able to pay its debts that become due within the next year.

Note: We have assumed that Hanson will not have an issue collecting the two accounts receivable $(\$8,000 + \$4,000)$ especially the current receivable of $8,000.

You could make the argument if it isn't collected, the liquidity of Hanson would not be good.

E 1-41

(a) is incorrect. Current assets are reasonably expected to be converted into cash within one year or one operating cycle, whichever is longer.
(b) is correct.
(c) is correct.
(d) is incorrect, as property, plant, and equipment does not include intangible assets.
(e) is correct.
(f) is incorrect – liabilities can be satisfied by cash or by providing a good or service.

Therefore**:**

b, c, and e are all correct.

E 1-42

The statement of financial position at December 31, 2022, will show equipment at its historical cost of $425,000 reduced by accumulated depreciation (a contra-asset) of $40,000. Therefore, the net book value (or carrying value) of the equipment is $385,000. (*Note:* The concepts of *book value* and *carrying value* will be covered in more detail in later chapters.) The equipment and accumulated depreciation will be reported under the caption "Property, plant, and equipment" in the asset section of the statement of financial position.

The 2022 statement of earnings will show depreciation expense of $40,000. In a multiple-step statement of earnings, depreciation expense will be reported as an operating expense.

E 1-43

Mulcahy Manufacturing Inc.
Partial Statement of Financial Position
December 31, 2022

Shareholders' equity:	
Common shares……	$135,600
Retained earnings……	25,300

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Total shareholders' equity……	$160,900

Note: Transactions among shareholders do not change shareholders' equity balances.

E 1-44

1.

College Spirit
Statement of Financial Position
December 31, 2022

Assets

Current assets:		
Cash……	$13,300	
Accounts receivable……	6,700	
Inventory……	481,400	
Prepaid rent……	54,000	
Total current assets……		$555,400
Long-term investments:		
Investment……		110,900
Property, plant, and equipment:		
Furniture……	88,000	
Less: Accumulated depreciation……	(23,700)	64,300
Total assets……		$730,600

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable……	$104,700	
Note payable……	50,000	
Income taxes payable……	11,400	
Total current liabilities……		$166,100
Long-term liabilities:		
Bonds payable……		180,000
Total liabilities……		346,100

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Shareholders' equity:		
Common shares	300,000	
Retained earnings	84,500	
Total shareholders' equity		384,500
Total liabilities and shareholders' equity		$730,600

2. College Spirit has working capital of $\$389,300 (\$555,400 - \$166,100)$ and a current ratio of $3.34 (\$555,400 \div \$166,100)$.

3. The working capital and current ratio show that College Spirit has adequate current assets to cover all of the current liabilities that will become due in the near future. Therefore, College Spirit's liquidity should not be a major concern. Comparing these items to those of other companies in the same industry and examining the trends in these measures over time will yield additional insights.

E 1-45

1.

Bathsheba Company
Statement of Financial Position
December 31, 2022
Assets

Current assets:		
Cash	$11,400	
Investments (short-term)	21,000	
Accounts receivable	95,500	
Prepaid insurance	5,700	
Inventory	187,900	
Total current assets		$321,500
Long-term investments:		
Investments		32,700
Property, plant, and equipment:		
Land		41,000

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Building	419,900	
Less: Accumulated depreciation	(216,800)	203,100
Trucks	106,100	
Less: Accumulated depreciation	(31,200)	74,900
Equipment (data processing)	309,000	
Less: Accumulated depreciation	(172,400)	136,600
Total property, plant and equipment		455,600
Total assets		$809,800

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable	$65,100	
Notes payable (due June 1, 2023)	150,000	
Salaries payable	14,400	
Interest payable	12,600	
Income taxes payable	21,600	
Total current liabilities		$263,700
Long-term liabilities:		
Bonds payable (due 2025)		200,000
Total liabilities		463,700
Shareholders' equity:		
Common shares	150,000	
Retained earnings*	196,100	
Total shareholders' equity		346,100
Total liabilities and shareholders' equity		$809,800

* *Note:* Retained earnings is computed using the concepts implied by the basic accounting equation. Because assets must equal liabilities plus shareholders' equity, retained earnings is computed by determining the amount that causes both sides of the basic accounting equation to remain equal. This amount is computed as:

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First, compute shareholders' equity as:

$$\text{Total assets} = \text{Total liabilities} + \text{Total shareholders' equity}$$
$$\$809,800 = \$463,700 + X$$
$$X = \$346,100$$

Next, compute retained earnings:

$$\text{Total shareholders' equity} = \text{Common shares} + \text{Retained earnings}$$
$$\$346,100 = \$150,000 + Y$$
$$Y = \$196,100$$

2. Bathsheba has working capital of $\$57,800 (\$321,500 - \$263,700)$ and a current ratio of $1.22 (\$321,500 \div \$263,700)$

3. While Bathsheba appears to be liquid, inventory is its largest current asset at $187,900. If a large portion of inventory cannot be sold, Bathsheba will most likely not generate sufficient cash flow to pay its obligations as they become due.

E 1-46

1.

Sayed Company
Statement of Earnings
For a Period of Time

Revenues:

Sales revenue

Expenses:

Cost of goods sold

Advertising expense

Salaries expense Utilities

expense Depreciation

expense Interest expense

Income tax expense

Net income

2. Information contained on the statement of earnings can be used to predict a company's ability to generate future income. Specifically, by examining a company's net profit margin $(\text{net income} \div \text{sales revenue})$, a

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financial statement decision-maker can gain insights into management's ability to control expenses, a critical factor to achieve future profitability.

E 1-47

1.

ERS Ltd.
Statement of Earnings
For the year ended December 31, 2022

Revenues:		
Service revenue		$933,800
Expenses:		
Wages expense	$448,300	
Salaries expense	195,600	
Supplies expense	66,400	
Rent expense	58,400	
Utilities expense	26,100	
Advertising expense	24,200	
Depreciation expense	16,250	
Insurance expense	11,900	
Interest expense	10,100	
Income tax expense	15,150	
Total expenses		872,400
Net income		$61,400

2. Net profit margin is $6.58\%\left(\$61,400\,\text{net income} \div \$933,800\,\text{service revenue}\right)$.

This indicates that $0.066 of each sales dollar is net income. If ERS were to increase revenues by $100,000, an additional $6,600 of net income would be recognized.

If ERS wanted to achieve larger profits, it should focus on controlling its expenses.

3. One possible reason for a declining profit margin implies that ERS is having difficulty maintaining control over its expenses. While further investigation is warranted to determine the cause of the growing expenses (e.g., is it due to increasing costs that are within management control or are the cost increases due to economic factors beyond ERS's short-term control), the declining profit margin signals that ERS may have difficulty generating future profits that are comparable with its past performance.

Another explanation is that competition has increased and the company has lost the ability to mark-up its products as it did in the past and has had to resort to heavy discounting (lower selling price).

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E 1-48

Bergin Pastry Shop
Statement of Earnings
For one year

Net sales	$85,300
Cost of goods sold*	50,600
Gross margin	34,700
Operating expenses**	25,500
Income from operations	9,200
Other expenses and losses:	
Interest expense	1,800
Income before taxes	7,400
Income tax expense***	1,110
Net income	$6,290

* Cost of goods sold is computed as net sales ($85,300) less gross margin ($34,700).

** Operating expenses are computed as gross margin ($34,700) less income from operations ($9,200).

*** $0.15 \times \$7,400$

E 1-49

1.

Wang Auto Supply
Statement of Earnings
For the Year Ended December 31, 2022

Revenues:		
Sales revenue		$583,900
Expenses:		
Cost of goods sold	$277,000	
Wages expense	98,250	
Salaries expense	32,000	
Depreciation expense	29,000	
Rent expense	18,000	

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Interest expense	2,700	
Income tax expense	38,085	
Total expenses		495,035
Net income		$88,865

2.

Wang Auto Supply
Statement of Earnings
For the Year Ended December 31, 2022

Sales revenue		583,900
Cost of goods sold		277,000
Gross margin		306,900
Operating expenses:		
Wages expense	$98,250	
Salaries expense	32,000	
Depreciation expense	29,000	
Rent expense	18,000	177,250
Income from operations		129,650
Other expenses and losses:		
Interest expense		2,700
Income before taxes		126,950
Income tax expense		38,085
Net income		$88,865

3. Both a single-step statement of earnings and a multiple-step statement of earnings report the same amount for net income. However, a single-step statement of earnings only contains two categories—total revenues and total expenses. These two categories are subtracted to arrive at net income. A multiple-step statement of earnings provides three important classifications that financial statement decision-makers find useful—gross margin, income from operations, and net income. The only difference between the two formats is how the revenues and expenses are classified.

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E 1-50

1.

Beginning retained earnings……		$18,240
+	Net income $(\$837,400 - \$792,100)$ ……	45,300
–	Dividends……..……	(38,650)
=	Ending retained earnings……	$24,890

2. Sherwood is paying $85\%(\$38,650 \div \$45,300)$ of its income to its shareholders in the form of dividends.

This large dividend payout will result in investors receiving relatively more of the company's earnings in the form of cash during the year rather than in share appreciation.

Financial statement decision-makers should examine the dividend payout ratio in relation to the firm's current ratio and working capital to ensure that Sherwood is not paying too much in dividends so that it will be able to repay its debts when they become due.

E 1-51

1.

Cash flow from operating activites:		
Cash received from customers……	$139,800	
Cash paid for advertising……	(34,200)	
Cash paid to employees for salaries……	(46,400)	
Cash paid for supplies……	(28,700)	
Net cash provided by operating activities……		$30,500
Cash flow from investing activities:		
Cash paid for purchase of land and building……	–128,700.00	
Cash paid to purchase machine……	–32,000	
Net cash used by investing activities……		(160,700)
Cash flow from financing activities:		
Cash received from owners……	201,500	
Cash paid for dividends to shareholders……	–139,800	

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Net cash provided by financing activities ……	61,700

2. Walters has positive cash flow from operations, showing the company has the ability to pay its debts (smaller type liabilities) as they come due in the short-term. If the company had a significant loan coming due, further investigation would be required to assess its ability to pay off that debt.

The negative cash flow (cash outflow) in investing is a sign of a growing company that is investing in revenue-producing assets. In addition, from the large amount of cash received from financing activities, it appears that Walters is able to raise large amounts of capital to finance its operations.

E 1-52

Cash at the end of the year:

Cash flow from operating activites……	$857,300
Cash outflow for investing activities……	(994,500)
Cash flow from financing activities……	156,600
Change in cash……	19,400
Add: Cash at 12/31/21……	17,400
Cash at 12/31/22……	$36,800

Retained earnings at end of 2022:

Retained earnings at 12/31/21……	$103,600
Add: 2022 net income $(\$673,900 - \$587,100)$ ……	86,800
Less: 2022 dividends……	(34,200)
Retained earnings at 12/31/22……	$156,200

E 1-53

From the information given in the problem and the fundamental accounting equation:

	Assets	=	Liabilities	+	Equity
12/31/2021	$72,400	=	$12,100	+	($50,000 + Retained Earnings)
12/31/2022	$78,500	=	$9,800	+	($50,000 + Retained Earnings)

For each year, solve for retained earnings:

12/31/2021

$$\text{Retained Earnings} = \text{Assets} - \text{Liabilities} - \text{Common Shares}$$

$$\text{Retained Earnings} = \$72,400 - \$12,100 - \$50,000$$

$$\text{Retained Earnings} = \$10,300$$

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12/31/2022	Retained Earnings	=	$\text{Assets} - \text{Liabilities} - \text{Common Shares}$
	Retained Earnings	=	$\$78,500 - \$9,800 - \$50,000$
	Retained Earnings	=	$18,700

Using the computed amounts for retained earnings, dividends can be determined using the relationships found in the statement of retained earnings.

Beginning retained earnings……		$10,300
+	Net income……	14,300
−	Dividends…	?
=	Ending retained earnings	$18,700

$\text{Dividends} = \$5,900$

E 1-54

From the information given in the problem and the basic accounting equation:

	Assets	=	Liabilities	+	Equity
12/31/2021	$144,200	=	$52,600	+	$(\$60,000 + \text{Retained Earnings})$
12/31/2022	$178,100	=	$59,700	+	$(\$60,000 + \text{Retained Earnings})$

For each year, solve for retained earnings:

12/31/2021	Retained Earnings	=	$\$144,200 - \$52,600 - \$60,000 = \$31,600$
12/31/2022	Retained Earnings	=	$\$178,100 - \$59,700 - \$60,000 = \$58,400$

Using the computed amounts for retained earnings, net income can be determined using the relationships found in the statement of retained earnings.

Beginning retained earnings……		$31,600
+	Net income……	?
–	Dividends……	(14,500)
=	Ending retained earnings…	$58,400

$\text{Net income} = \$41,300$

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E 1-55

a. Management's discussion and analysis

b. Notes to the financial statements

c. Notes to the financial statements

d. Financial statements (statement of financial position)

e. Management's discussion and analysis

f. Financial statements (statement of cash flows)

g. Report of independent auditors

h. Financial statements (Statement of earnings)

E 1-56

a. Unethical (U) - misleading financial statements for personal gain.

b. Ethical (E) - correct thing to do based on the standards for auditors.

c. Unethical (U) - not performing his or her work as required to do so. Must put personal relationships aside.

d. Ethical (E) - This is the obligations of a good accounant/CPA.

e. Ethical (E) - No issues here. If all proper steps have been followed.

f. Unethical, and probably illegal (U) - clearly this is not allowed.

g. Ethical (E) - Since it is confidential, the accountant is doing as he or she should and not disclosing this information.

h. Unethical (U) - a clear breach of the rules of professional conduct and is therefore une

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PROBLEM SET A

P 1-57A

The basic accounting equation requires that there be an equality between assets and liabilities plus shareholders' equity. Therefore, the amount of liabilities that Huffer must have at the end of 2022 can be inferred from the basic accounting equation if both assets and shareholders' equity are known.

The amount of Huffer's assets at 12/31/22 is $278,200. Huffer's shareholders' equity at the end of 2022 is the amount of shareholders' equity at the beginning of the year plus (minus) net income (loss) less dividends plus the sale of common shares.

	Common Shares	+	Retained Earnings	=	Shareholders' Equity
Equity, 12/31/21	$80,000	+	$62,600	=	$142,600
Net income			42,750		
Dividends			(11,900)		
Common shares issued	12,800				
Equity, 12/31/22	$92,800	+	$93,450	=	$186,250

The amount of liabilities that Huffer must have at the end of 2022 is determined by using the statement of financial position equation and solving for the missing amount.

	Assets	=	Liabilities	+	Equity
At 12/31/22	$278,200	=	?	+	$186,250

$$\text{Liabilities} = \$278,200 - \$186,250 = \$91,950$$

P 1-58A

It is sometimes necessary to answer these questions out of order because of the way the relationships among the accounts work.

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity (all at end of the year)}$$

(a)
$$\text{Assets} = \$126,900 + \$104,100$$
$$\text{Assets} = \$231,000$$

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity (all at the beginning of the year)}$$

(b)
$$\$145,200 = \$92,600 + \text{Shareholders' Equity}$$
$$\text{Shareholders' Equity} = \$52,600$$

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$$\text{Beginning Shareholders' Equity} + \text{Net Income} - \text{Dividends} = \text{Ending Shareholders' Equity}$$

(c) $\$52,600 + \$77,500 - \text{Dividends} = \$104,100$

$\text{Dividends} = \$26,000$

$$\text{Revenues} - \text{Expenses} = \text{Net Income}$$

(d) $\$554,800 - \text{Expenses} = \$77,500$

$\text{Expenses} = \$477,300$

P 1-59A

Perez Wrecking Service
Statement of Earnings
For the Year Ended December 31, 2022

Revenues:		
Service revenue	$425,000	
Sales revenue	137,000	
Interest income	1,575	
Total revenues		$563,575
Expenses:		
Wages expense	$243,200	
Rent expense	84,000	
Supplies expense	48,575	
Depreciation expense	24,150	
Miscellaneous expense	17,300	
Income tax expense	43,900	
Total expenses		461,125
Net income		$102,450

P 1-60A

Floyd:

Revenues	–	Expenses	=	Net Income
$125	–	$92	=	$33 (a)
Assets	=	Liabilities	+	Shareholders' Equity
$905	=	$412	+	$493 (b)

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Singh:

Revenues	–	Expenses	=	Net Income
$715	–	$531(c)	=	$184
Assets	=	Liabilities	+	Shareholders' Equity
$1,988	=	$1,165(d)	+	$823

Wang:

Revenues	–	Expenses	=	Net Income
$72(e)	–	$54	=	$18
Assets	=	Liabilities	+	Shareholders' Equity
$197(f)	=	$117	+	$80

O'Bannion:

Revenues	–	Expenses	=	Net Income (Net Loss)
$2,475	–	$3,075(g)	=	(600)
Assets	=	Liabilities	+	Shareholders' Equity
$8,140	=	$2,280	+	$5,860(h)

P 1-61A

Roget Enterprises
Statement of Earnings
For the Year Ended December 31, 2022

Revenues:		
Service revenue		$463,500
Expenses:		
Salaries expense	$235,200	
Rent expense	135,000	
Supplies expense	34,400	
Interest expense	16,000	
Income tax expense	12,800	433,400
Net income		$30,100

Roget Enterprises
Statement of Financial Position
December 31, 2022
Assets

Current assets:	
Cash	$13,240
Accounts receivable	72,920

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Supplies	42,000	
Prepaid rent	31,500	
Total current assets		$159,660
Property, plant, and equipment		90,000
Total assets		$249,660

Liabilities and Shareholders' Equity

Current liabilities:		
Salaries payable	$14,800	
Income taxes payable	4,150	
Total current liabilities		$ 18,950
Long-term liabilities:		
Notes payable (due in 10 years)		25,000
Total liabilities		43,950
Shareholders' equity:		
Common shares (10,000 shares)	70,000	
Retained earnings*	135,710	
Total shareholders' equity		205,710
Total liabilities and shareholders' equity		$249,660

* Retained earnings is computed as the amount needed to make the basic accounting equation balance.

P 1-62A

Net cash provided from operating activities		$5,000
Net cash used by investing activities	2,500	
Net cash provided from financing activities	2,500	
Net change in Cash		5,000
Cash, 1/1/2022		$ 13,000
Cash, 12/31/2022		$18,000

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P 1-63A

Dittman Expositions

Statement of Retained Earnings

For the Years Ended December 31, 2021, and December 31, 2022

	2021	2022
Retained earnings, beginning of year*	$16,900	$41,850
Add: Net income**	33,200	29,800
Less: Dividends	(8,250)	(9,910)
Retained earnings, end of year	$41,850	$61,740

* The ending retained earnings balance for 2021 becomes the beginning retained earnings balance for 2022.

** Net income computed as follows:	2021	2022
Revenue	$419,700	$442,400
Less: Expenses	(386,500)	(412,600)
Net income	$33,200	$29,800

P 1-64A

(a) $\$30,700 - \text{Dividends (a)} = \$27,200$

$\text{Dividends} = \$3,500$

(b) $\text{Retained Earnings, Beginning}(2021) = \text{Retained Earnings, Ending (2020)} = \$27,200$

(c) $\text{Retained Earnings, Beginning (b)} + \text{Net Income} = \text{(c)}$

$\$27,200 + \$10,100 = \$37,300$

You must solve for (e) prior to solving for (d):

(e) $\text{Retained Earnings, Ending (2021)} = \text{Retained Earnings, Beginning (2022)} = \$33,600$

$\text{Retained Earnings, Ending (e)} = \text{(c)} - \text{Dividends (d)}$

(d) $\$33,600 = \$37,300 - \text{(d)}$

$\text{(d)} = \$3,700$

You must solve for (g) prior to solving for (f):

$\text{Retained Earnings, Ending} = \text{(g)} - \text{Dividends}$

(g) $\$41,200 = \text{(g)} - \$3,900$

$\text{(g)} = \$45,100$

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Retained Earnings, Beginning + Net Income (f) = (g)

(f) $\$33,600 + (f) = \$45,100$

$(f) = \$11,500$

P 1-65A

1.

Ishtar Appliances
Statement of Earnings
For the Year Ended December 31, 2022

Revenues:		
Sales revenue		$948,670
Expenses:		
Cost of goods sold	$511,350	
Wages expense	127,710	
Salaries expense	101,000	
Rent expense	80,800	
Insurance expense	36,610	
Interest expense	15,500	
Depreciation expense (furniture)	12,000	
Depreciation expense (building)	11,050	
Income tax expense	16,650	
Total expenses		912,670
Net income		$36,000

Ishtar Appliances
Statement of Retained Earnings
For the Year Ended December 31, 2022

Beginning retained earnings, 12/31/21	$54,000
Add: Net income*	36,000
Ending retained earnings, 12/31/22	$90,000

* From the statement of earnings

Ishtar Appliances

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Statement of Financial Position

December 31, 2022

Assets

Current assets:			
Cash		$41,450	
Accounts receivable		69,900	
Inventory		59,850	
Total current assets			$171,200
Property, plant, and equipment:			
Building	$300,000		
Less: Accumulated depreciation	(104,800)	195,200	
Furniture	130,000		
Less: Accumulated depreciation	(27,600)	102,400	
Total property, plant, and equipment			297,600
Other assets			92,800
Total assets			$561,600

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable	16,800	
Income taxes payable	12,000	
Salaries payable	7,190	
Total current liabilities		35,990
Long-term liabilities:		192,000
Bonds payable		$227,990
Total liabilities		
Shareholders' equity:		
Common shares	243,610	
Retained earnings*	90,000	
Total shareholders' equity		333,610
Total liabilities and shareholders' equity		$561,600

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* From the retained earnings statement

2. Both a single-step statement of earnings and a multiple-step statement of earnings report the same amount for net income. However, a single-step statement of earnings only contains two categories—total revenues and total expenses. These two categories are subtracted to arrive at net income. A multiple-step statement of earnings provides three important classifications that financial statement decision-makers find useful—gross margin, income from operations, and net income. The only difference between the two formats is how the revenues and expenses are classified.

P 1-66A

Berko Company:

(a) $\$62,100 \quad (\$50,000 + \$12,100)$

(b) $\$17,100 \quad (\$12,100 + \$7,000 - \$2,000)$

(c) $\$67,100 \quad (\$17,100 + \$50,000)$

(d) $\$25,400 \quad (\$92,500 - \$67,100)$

Manning Company:

(e) $\$9,300 \quad (\$44,300 - \$35,000)$

(f) $\$7,500 \quad (\$9,300 - \$1,800)$

(g) $\$42,500 \quad (\$35,000 + \$7,500)$

(h) $\$57,300 \quad (\$42,500 + \$14,800)$

Lucas Company:

(i) $\$40,000 \quad (\$66,400 - \$26,400)$

Must solve for (k) before (j):

(k) $\$29,500 \quad (\$84,500 - \$55,000)$

(j) $\$2,900 \quad (\$26,400 + \$6,000 - \$29,500)$

(l) $\$14,700 \quad (\$99,200 - \$84,500)$

Perlman Company:

(m) $\$7,100 \quad (\$27,600 - \$21,900 + \$1,400)$

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(n) $\$42,600 \quad (\$15,000 + \$27,600)$

(o) $\$53,300 \quad (\$10,700 + \$42,600)$

P 1-67A

First, use the basic accounting equation to determine shareholders' equity:

	Assets	=	Liabilities	+	Shareholders' Equity
Beginning	$392,500	=	$148,550	+	$243,950*
End	$415,100	=	$149,600	+	$265,500**

* $\$392,500 - \$148,550 = \$243,950$

** $\$415,100 - \$149,600 = \$265,500$

Next, use these fundamental relationships to solve for each situation:

$$\text{Shareholders' Equity} = \text{Common Shares} + \text{Retained Earnings}$$
$$\text{Change in Shareholders' Equity} = \text{Change in Common Shares} + \text{Change in Retained Earnings}$$
$$\text{Change in Retained Earnings} = \text{Net Income} - \text{Dividends}$$

Therefore,

$$\text{Change in Shareholders' Equity} = \text{Change in Common Shares} + \text{Net Income} - \text{Dividends}$$

1. $(\$265,500 - \$243,950) = \$0 + \text{Net Income} - \$0$
$\text{Net Income} = \$21,550$

2. $(\$265,500 - \$243,950) = \$33,000 + \text{Net Income} - \$0$
$\text{Net Loss} = \$11,450$

3. $(\$265,500 - \$243,950) = \$0 + \text{Net Income} - \$11,000$
$\text{Net Income} = \$32,550$

4. $(\$265,500 - \$243,950) = \$29,000 + \text{Net Income} - \$17,000$
$\text{Net Income} = \$9,550$

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PROBLEM SET B

P 1-68B

The basic accounting equation requires that there be an equality between assets and liabilities plus shareholders' equity. Therefore, the amount of liabilities that KJ Corporation must have at the end of 2022 can be inferred from the basic accounting equation if both assets and shareholders' equity are known.

The amount of KJ's assets at 12/31/22 is $721,800. KJ's shareholders' equity at the end of 2022 is the amount of shareholders' equity at the beginning of the year plus (minus) net income (loss) less dividends plus the sale of common share.

	Common Shares	+	Retained Earnings	=	Shareholders'Equity
Equity, 12/31/21	$139,000	+	$152,900	=	$291,900
Net income			225,200		
Dividends			(74,400)		
Common shares issued	94,000		_____		_____
Equity, 12/31/22	$233,000	+	$303,700	=	$536,700

The amount of liabilities that KJ must have at the end of 2022 is determined by using the statement of financial position equation and solving for the missing amount.

	Assets	=	Liabilities	+	Equity
At 12/31/22	$721,800	=	?	+	$536,700

$$\text{Liabilities} = \$721,800 - \$536,700 = \$185,100$$

P 1-69B

It is sometimes necessary to answer these questions out of order because of the way the relationships between the accounts work.

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity (all at the beginning of the year)}$$

(a) $$\text{Assets} = \$368,200 + \$272,900$$

$$\text{Assets} = \$641,100$$

Note: Item (d) is found prior to finding items (b) and (c).

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$$\text{Net Income} = \text{Revenues} - \text{Expenses}$$

(d) $\text{Net Income} = \$929,440 - \$835,320$

$$\text{Net Income} = \$94,120$$

Note: Item (c) is found prior to finding item (b).

$$\text{Beginning Shareholders' Equity} + \text{Net Income} - \text{Dividends} = \text{Ending Shareholders' Equity}$$

(c) $$\$272,900 + \$94,120 - \$35,500 = \text{Ending Shareholders' Equity}$$

$$\text{Ending Shareholders' Equity} = \$331,520$$

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity (all at end of year)}$$

(b) $\$758,150 = \text{Liabilities} + \$331,520$

$$\text{Liabilities} = \$426,630$$

P 1-70B

Kim Renovation Inc.
Statement of Earnings
For the Year Ended December 31, 2022

Revenues:		
Service revenue	$763,400	
Interest income	5,475	
Total revenues		$768,875
Expenses:		
Wages expense	$222,900	
Depreciation expense	135,000	
Utilities expense	109,300	
Insurance expense	65,850	
Miscellaneous expense	31,000	
Income tax expense	61,400	
Total expenses		625,450
Net income		$143,425

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P 1-71B

Crick:

$$\text{Net Income} = \text{Revenues} - \text{Expenses}$$
$$\$81 \quad (a) = \$925 - \$844$$
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$
$$\$709 = \$332 + \$377 \quad (b)$$

Pascal:

$$\text{Net Income} = \text{Revenues} - \text{Expenses}$$
$$\$289 = \$533 - \$244 \quad (c)$$
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$
$$\$1,810 = \$860 \quad (d) + \$950$$

Eiffel:

$$\text{Net Income} = \text{Revenues} - \text{Expenses}$$
$$\$126 = \$503 \quad (e) - \$377$$
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$
$$\$552 \quad (f) = \$454 + \$98$$

Hilbert:

$$\text{Net Income (Loss)} = \text{Revenues} - \text{Expenses}$$
$$-\$340 = \$1,125 - \$1,465 \quad (g)$$
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$
$$\$3,150 = \$2,267 + \$883 \quad (h)$$

P 1-72B

Ross Airport Auto Service
Statement of Earnings
For the Year Ended December 31, 2022

Revenues:		
Service revenue (parking).....	$232,600	
Service revenue (repair).....	198,500	
Interest income.....	4,100	
Total revenues.....		$435,200
Expenses:		
Wages expense.....	$246,100	

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Rent expense	103,500	
Supplies expense	36,900	
Interest expense	21,300	
Depreciation expense	12,450	
Income tax expense	2,700	
Total expenses		422,950
Net income		$12,250

Ross Airport Auto Service
Statement of Financial Position
December 31, 2022
Assets

Current assets:		
Cash	$7,700	
Accounts receivable	39,200	
Inventory	6,100	
Prepaid rent	27,300	
Total current assets		$80,300
Long-term investments:		
Investments		35,000
Property, plant, and equipment:		
Equipment	270,800	
Less: Accumulated depreciation	(42,300)	228,500
Total assets		$343,800

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable	$17,200	
Wages payable	12,500	
Income taxes payable	1,100	
Interest payable	4,800	
Total current liabilities		$35,600
Long-term liabilities:		
Notes payable		160,000
Total liabilities		195,600
Shareholders' equity:		
Common shares	100,000	
Retained earnings	48,200	

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Total shareholders' equity……	148,200
Total liabilities and shareholders' equity……	$343,800

Note: Dividends do not appear on the statement of earnings or the statement of financial positi Instead, dividends are reported on the statement of retained earnings.

P 1-73B

Net cash provided from operating activities		$7,500	
Net cash used by investing activities	−3,000		
Net cash provided from financing activities Net Change in Cash	4,000		
			8,500
Cash, 12/31/2021			$13,000
Cash, 12/31/2022			$21,500

P 1-74B

Magical Experiences Vacation Company
Statement of Retained Earnings
For the Years Ended December 31, 2021, and December 31, 2022

	2021	2022
Retained earnings, beginning of year*……	$47,100	$93,500
Add: Net income**……	59,600	82,800
Less: Dividends……	(13,200)	(15,900)
Retained earnings, end of year……	$93,500	$160,400

* The ending retained earnings balance for 2021 becomes the beginning retained earnings balance for 2022.

** Net income computed as follows	2021	2022
Revenue……	$244,900	$391,400
Less: Expenses……	(185,300)	(308,600)
Net income……	$59,600	$82,800

P 1-75B

(a) $\$26,900 - \$11,100 = \$15,800$

(b) $\text{Retained Earnings, Ending (2020)} = \text{Retained Earnings, Beginning (2021)} = \$19,500$

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You must solve for (e) prior to solving for (c) or (d):

(e) $\text{Retained Earnings, Ending (2021)} = \text{Retained Earnings, Beginning (2022)} = \$26,700$

You must solve for (d) prior to solving for (c):

(d) $\$26,700\,(e) + \$5,200 = \$31,900$

(c) $\$31,900\,(d) - \$19,500 = \$12,400$

(f) $\$26,700 + \$9,500 = \$36,200$

(g) $\$36,200\,(f) - \$34,100 = \$2,100$

P 1-76B

McDonald Marina
Statement of Earnings
For the Year Ended December 31, 2022

Revenues:		
Service revenue (docking)…	$1,460,000	
Service revenue (cleaning)	472,300	
Total service revenues		$1,932,300
Expenses:		
Wages expense	987,200	
Depreciation expense (equipment)	246,300	
Utilities expense	239,400	
Interest expense	236,000	
Supplies expense	89,100	
Depreciation expense (building)	21,500	
Rent expense	14,600	
Income tax expense	21,700	
Total expenses		1,855,800
Net income		$76,500

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McDonald Marina
Statement of Retained Earnings
For the Year Ended December 31, 2022

Retained earnings, 12/31/21	$128,600
Add: Net income for 2022	76,500
Less: Dividends	(25,300)
Retained earnings, 12/31/22	$179,800

McDonald Marina
Statement of Financial Position
December 31, 2022
Assets

Current assets:			
Cash		$22,300	
Accounts receivable		268,700	
Supplies		9,800	
Total current assets			$ 300,800
Property, plant, and equipment:			
Land		875,000	
Building	$197,300		
Less: Accumulated depreciation	(64,500)	132,800	
Equipment	2,490,000		
Less: Accumulated depreciation	(950,400)	1,539,600	
Total property, plant, and equipment			2,547,400
Total assets			$2,848,200

Liabilities and Shareholders' Equity

Current liabilities:	
Accounts payable	$26,400
Wages payable	21,600
Interest payable	18,000
Rent payable	2,400

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Total current liabilities…….		$68,400
Long-term liabilities:		
Bonds payable……		2,000,000
Total liabilities……		2,068,400
Shareholders' equity		
Common shares……	600,000	
Retained earnings……	179,800	
Total shareholders' equity……		779,800
Total liabilities and shareholders' equity……		$2,848,200

2. Both a single-step statement of earnings and a multiple-step statement of earnings report the same amount for net income. However, a single-step statement of earnings only contains two categories—total revenues and total expenses. These two categories are subtracted to arrive at net income. A multiple-step statement of earnings provides three important classifications that financial statement decision-makers find useful—gross margin, income from operations, and net income. The only difference between the two formats is how the revenues and expenses are classified.

P 1-77B

Stackhouse Company:

(a) $\$5,000 (\$21,700 - \$18,800 + \$2,100)$

(b) $\$66,700 (\$45,000 + \$21,700)$

(c) $\$81,100 (\$14,400 + \$66,700)$

Compton Company:

(d) $\$54,300 (\$39,000 + \$15,300)$

(e) $\$21,600 (\$15,300 + \$7,100 - \$800)$

(f) $\$60,600 (\$21,600 + \$39,000)$

(g) $\$27,600 (\$88,200 - \$60,600)$

Bellefleur Company:

Must solve for (i) first.

(i) $\$15,300 (\$95,300 - \$80,000)$

(h) $\$1,300 (\$6,900 + \$9,700 - \$15,300)$

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(j) $\$18,100(\$113,400 - \$95,300)$

Merlotte Company:

(k) $\$13,900(\$38,900 - \$25,000)$

(l) $\$9,400(\$13,900 - \$4,500 - \$0)$

(m) $\$34,400(\$25,000 + \$9,400)$

(n) $\$50,100(\$15,700 + \$34,400)$

P 1-78B

First, use the basic accounting equation to determine shareholders' equity:

	Assets	**=**	**Liabilities**	**+**	**Shareholders' Equity**	
Beginning	$231,500	=	$84,550	+	$146,950	*
End	$348,100	=	$125,900	+	$222,200	**

* $\$231,500 - \$84,550 = \$146,950$

** $\$348,100 - \$125,900 = \$222,200$

Next, use these fundamental relationships to solve for each situation:

$$\text{Shareholders' Equity} = \text{Common Shares} + \text{Retained Earnings}$$
$$\text{Change in Shareholders' Equity} = \text{Change in Common Shares} + \text{Change in Retained Earnings}$$
$$\text{Change in Retained Earnings} = \text{Net Income} - \text{Dividends}$$

Therefore,

$$\text{Change in Shareholders' Equity} = \text{Change in Common Shares} + \text{Net Income} - \text{Dividends}$$

1. $(\$222,200 - \$146,950) = \$0 + \text{Net Income} - \$0$
$\text{Net Income} = \$75,250$

2. $(\$222,200 - \$146,950) = \$12,000 + \text{Net Income} - \$0$
$\text{Net Income} = \$63,250$

3. $(\$222,200 - \$146,950) = \$0 + \text{Net Income} - \$8,000$
$\text{Net Income} = \$83,250$

4. $(\$222,200 - \$146,950) = \$15,000 + \text{Net Income} - \$11,000$
$\text{Net Income} = \$71,250$

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CASES

Case 1-79

Answers to this question may vary; however, many students will focus on income. If Jim had kept track of his revenues (his earnings from the summer job, the small scholarship, and the fixed amount from his parents) and his expenses (e.g., tuition, books, apartment, entertainment) during earlier semesters, he might have been able to budget for the spring term. Many of his expenses will be the same or very similar from term to term.
Jim could use the information from the fall term to predict what his revenues and expenses would be for the spring term. He would then have a better idea of how much he could spend on entertainment without "maxing out" his credit card. In addition, Jim could keep track of his assets and liabilities. He could track which assets were current (e.g., cash in his bank account) and which liabilities would be coming due in the near term (e.g., spring tuition, living expenses). He could then know prior to the spring term which bills would be coming due and if he had enough liquid assets to pay these bills. Keeping better track of his revenues, expenses, income, assets, and liabilities may have allowed Jim to avoid overspending his resources.

Case 1-80

1. The following examples are illustrative:

a. Nonbusiness entities (including governments and educational institutions):
The Accounting Review (university and college educators), American Accounting Association
Issues in Accounting Education (university and college educators), American Accounting Association
The Canadian Academic Accounting Association (CAAA)

b. Business entities:
Strategic Finance (management accountants and finance professionals), Institute of Management Accountants
Financial Executive (controllers, treasurers, and senior financial executives), Financial Executives Institute
Internal Auditor (internal auditors), Institute of Internal Auditors

c. Public practice:
CPA Canada Magazine, CPA Canada
Journal of Accountancy (certified public accountants), American Institute of Certified Public Accountants
The CPA Journal (certified public accountants), New York State Society of CPAs

2. Activities and events in one segment of the accounting profession affect activities and events in other segments of the profession. Education affects preparedness for public practice. New business activities require new auditing procedures. Accounting research affects the practice of accounting, and accounting practice influences the form of accounting research. Information about developments outside one's own segment of accounting can help one better understand and, perhaps, shape developments inside one's own segment.

Case 1-81

Student responses to this assignment will vary widely, but it is a good basis for classroom discussion. Some students will have interests in various accounting careers; others will have interests in other business careers or perhaps graduate professional degrees. Of those with plans for graduate education, some intend to work for several years

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before returning for additional education; others will plan to go directly into graduate school. Some will plan to start their careers in one field and then move into another after several years. Some may have plans to start their own business. The steps necessary to implement these plans can be an interesting basis for discussion.

Case 1-82

1.

$$\begin{aligned}
&\text{Current assets}(1/31/22) &&= \$4,850 + \$27,409 + \$6,864 = \$39,123\\
&\text{Current liabilities}(1/31/22) &&= \$18,602\\
&\text{Current assets}(1/31/21) &&= \$3,408 + \$30,989 + \$7,440 = \$41,837\\
&\text{Current liabilities}(1/31/21) &&= \$33,384
\end{aligned}$$

Gekas Rent-A-Car reported a current ratio of 2.10 ($39,123 ÷ $18,602) in 2022 and a current ratio of 1.25 ($41,837 ÷ $33,384) in 2021. Its working capital is $20,521 ($39,123 – $18,602) in 2022 and $8,453 ($41,837 – $33,384) in 2022. These ratios show that the company has adequate current assets to cover the current liabilities in both years. In addition, its liquidity is improving between 2021 and 2022.

2.

$$\text{Net Income} = \text{Shareholders' Equity}(1/31/2022) - \text{Shareholders' Equity}(1/31/2021) + \text{Dividends}^*$$

$$\$157,515 - \$147,288 + \$18,100 = \$28,327$$

*

$$\text{Beg. Shareholders' Equity}\ \$147,288 + \text{Net Income} - \text{Dividends}\ \$18,100 = \text{End. Shareholders' Equity}\ \$157,515$$

Case 1-83

1. Trends:

(a) Revenues decreased dramatically from 2018 to 2022.

(b) Operating income (loss) has fluctuated dramatically in the five-year period, but shows some improvement (less of a loss) in 2022.

(c) Net income (loss) took a major hit in 2021 and seems to be slowly recovering in 2022 with a much smaller loss.

2. In 2018 and 2019, Brothers Aviation Company had adequate assets to cover the current liabilities, but the ratio changed dramatically in 2020, 2021, and 2022, causing current liabilities in 2022 to be larger than current assets. It seems as though revenue has decreased and a portion of current assets was used to pay down its long-term debt in 2020.

3. Yes, the company has shown a considerable decrease throughout the five-year period in net income and also shows that it may have difficulty in paying current liabilities with the small amount of current assets it has.

Case 1-84

Ethical behaviour by accountants is important to society because capital markets and businesses cannot operate efficiently or effectively without reliable financial information. Financial information determines the way in which

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resources are deployed and distributed. Thus, individuals who stand to benefit from changes in resource deployment or distribution have an incentive to misrepresent financial information or to pressure accountants to do so. Such individuals may even create financial incentives for accountants to bias or misrepresent the facts. Unethical behaviour by an accountant, once revealed, usually brings loss of employment and frequently loss of professional credentials as well.

Case 1-85

There are many ethical implications involved with the discussion between Lola and Frank. It is not ethical to change items in the financial statements simply to appear better to the public. This can be very misleading to both creditors and investors, and could potentially cause harm to these parties who based their expectations of future performance on the past numbers that have been changed. If the company doesn't perform as well as expected, these creditors and investors will likely blame the accounting numbers that have been misrepresented. If management intends to pay off accounts within a year, they need to be classified as current liabilities. Also, investments that have been purchased with the intent to hold them for a long period of time should be considered long-term investments.

Management should not reclassify these unless their intent changes and they plan to sell the investments within the next year. In addition, the company should follow generally accepted accounting principles and record its assets at historical cost. Management cannot pick and choose which assets to present at their market value. Management should not use the excuse of "judgment" to alter numbers in order to make the company appear better on paper.

Case 1-86

1. Canadian Tire's fiscal year ended on December 29, 2018. (2018 financial information) This year-e was different from previous years since the company has a floating year-end date (see Note 2 to the financial statements).
2. Canadian Tire presents two years of Consolidated Statement of Financial position (Consolidated Balance Sheet) information and two years of Statement of Earnings (Consolidated Statement of Income) information.
3. Statement of Financial Position Information:
   a. For December 29, 2018, Canadian Tire reported total assets of $17,286.8 (in millions), total liabilities of $11,871.8 (in millions), and total shareholders' equity of $5,415.0 (in millions)
   Note for the rest of the answer all numbers will be presented in C$ in millions.
   b. The dollar amounts for all three categories have changed in the past year. For 2017, Canadian Tire reported total assets of $15,627.0, total liabilities of $10,060.9, and total shareholders' equity of $5,566.1. This represented an increase in total assets of $\$1,659.8(\$17,286.8-\$15,627.0)$, an increase in total liabilities of $\$1,810.9(\$11,871.8-\$10,060.9)$, and a decrease in total shareholders' equity of $\$151.1(\$5,415.0-\$5,566.1)$. Canadian Tire experienced significant growth in its resources and claims against those resources during fiscal 2018.
   c. For December 29, 2018, Canadian Tire reported current assets of $9,255.8 and current liabilities of $5,258.2. For December 30, 2017, Canadian Tire reported current assets of $8,796.1 and current liabilities of $4,529.7.

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d. Canadian Tire reported working capital of $\$3,997.6 (\$9,255.8 - \$5,258.2)$ for 2018 and working capital of $\$4,266.4 (\$8,796.1 - \$4,529.7)$ for 2017. Canadian Tire's current ratio was $1.76 (\$9,255.8 \div \$5,258.2)$ for 2018 and $1.94 (\$8,796.1 \div \$4,529.7)$ for 2017. Canadian Tire's current assets are greater than its current liabilities for both years, which indicates that Canadian Tire should be able to pay the liabilities that become due within the next year. The numbers comparing fiscal 2018 to 2017 are very similar.

Liquidity has remained stable during the past two years, although the current ratio for 2017 is better compared to 2018. In absolute terms the numbers are very good.

4. Statement of Income/ Statement of Earnings information:

a. For fiscal 2018, Canadian Tire reported revenues (net sales) of $14,058.7 and cost of producing revenue of $9,347.4.

Income before income taxes nets to 1,068.2 Overall net income after taxes is 783.0

b. Sales have increased in the two-year period shown in the comparative Statement of Earnings. This has caused cost of sales (an expense) to increase as well. Both gross margin and net income have increased in absolute terms in fiscal 2018.

5. Statement of cash flows information:

For fiscal 2018, Canadian Tire reported a net cash inflow from operating activities of $807.4 , a net cash outflow for investing activities of $1,308.6, and a net cash inflow for financing activities of $534.6.

6. Management's discussion and analysis information:

a. Canadian Tire's management considers several accounting policies critical, including following International Financial Reporting Standards. Detailed information can be found in the management's discussion and analysis section of the annual report. More detail on significant accounting policies can also be found in the notes to the financial statements (Note 3).

b. The company does believe that it has performed well during the current year. Its analysis can be found in the management's discussion and analysis section in the annual report. Management lays out its beliefs on current operations as well as future prospects in this section of the annual report.

7. The financial statements are audited by Deloitte LLP.

Case 1-87

1. The first concern for Front Row Entertainment is to obtain financing for the business. Normally, a concert promoter must pay a significant amount of upfront cash to secure the venue and advertise the tour. Therefore, it is critical that Front Row Entertainment raise a large amount of cash if the business is to succeed. This cash may be raised by issuing debt (e.g., notes payable, bonds payable), shares (e.g., common shares), or a combination of both. Next, Front Row Entertainment must purchase the assets necessary to operate.

Because a concert promoter provides a service, the initial investment in property, plant, and equipment is likely to be relatively small and involve typical office equipment (e.g., desks, telephones, computers). These assets are normally combined and reported as equipment on the statement of financial position. The business can now begin to operate. Revenues (e.g., sales revenue, service revenue) will be generated as Front Row fulfills its

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contractual duties (e.g., sells tickets). One of the major expenses for a concert promoter would be the fees paid to the musical artist upon completion of the event (reported as cost of sales). In addition, Front Row Entertainment will likely incur large expenses initially as it books the venue and advertises the concert. Typical expenses may include rent expense (for office space of the business as well as a rental fee on the venue), utilities expense, salaries expense (for Cam and Anna's salaries), advertising expense, and insurance expense. Some of these expenses may be prepaid (resulting in accounts such as prepaid advertising or prepaid rent) while payment for others may be delayed (resulting in accounts such as accounts payable, salaries payable, and rent payable).

2. Cam and Anna can choose to organize Front Row Entertainment as either a partnership or a corporation. Relative to the corporate form of organization, partnerships are easier to organize. In addition, the control of the partnership would be shared by Cam and Anna, and the business would have access to the financial resources and skills of each partner. Finally, a partnership may pay less taxes than a corporation. This is because the corporate tax rate is higher than the individual tax rate and the corporation's income is taxed twice—once at the corporate level and again at the shareholder level as earnings are distributed. However, the corporate form also has advantages.

First, it can raise larger amounts of resources through the issuance of shares. Second, the corporate form limits the liability of its shareholders to the amount they have invested in the business. If the business were to fail, shareholders would only lose their investment. On the other hand, creditors could attempt to recover their losses from the personal assets of the partners. Finally, corporations have an unlimited life, with ownership easily transferred by the sale of shares. However, partnerships are often dissolved when any partner leaves the partnership. Cam and Anna need to carefully weigh the advantages and disadvantages of each form of business organization and select the form that best fits their needs.

3. Cam and Anna will need to prepare four basic financial statements: a statement of financial position, a statement of earnings, a statement of retained earnings, and a statement of cash flows. A statement of financial position reports the resources (assets) owned by a company and the claims against those resources (liabilities and shareholders' equity) at a specific point in time. By providing information about the structure of assets, liabilities, and shareholders' equity, a statement of financial position provides users insight into whether a company can pay its obligations as they become due (liquidity). A statement of earnings reports how well a company has performed its operations (revenues, expenses, and income) over a period of time. By providing information about a company's current profitability, decision-makers are better able to judge a company's ability to generate future income and growth potential. Such information impacts the decision of whether to make a loan to the company or invest in the company. A statement of retained earnings reports how much of a company's income was retained in the business and how much was distributed to owners over a period of time. Insights into a company's dividend policy assist investors in determining a company's ability to pursue future growth opportunities. Finally, a statement of cash flows reports the sources and uses of a company's cash over a period of time. This information allows investors and creditors to judge the ability of a company to generate cash in the future, as well as to assess the creditworthiness of a company and its ability to pay future dividends.

Case 1-88

A well thought-out response to this type of situation is to provide Lorraine with an understanding of the different forms of businesses organizations that she can set up.

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A discussion of the unethical practice of not reporting her full income should be addressed as well.

Option 1:

Sole Proprietorship

Is an unincorporated business, which is owned by one person; in this case, Lorraine. Usually a small, local business such as the one that Lorraine would want to set up.

It is very simple to set up and gives Lorraine control over her business. She is the only owner under this business organization.

The owner is personally responsible for the debts of the business. A sole proprietorship can be formed or dissolved at the wishes of the owner.

Some clear advantages and disadvantages of forming this business organization:

- Easy to form and less costly to set up and maintain
- Controlled by the owner
- Personal liability – Lorraine's personal assets could be at risk
- Limited life

Option 2:

Corporation

This is another option that is available to Lorraine. A corporation is a business organized under the laws of the province in which Lorraine resides in or under the laws of Canada. One or more owners can own a corporation. Owners are called shareholders. In this case Lorraine would be the sole shareholder.

Unlike a sole proprietorship, a corporation is an "artificial person" and the shareholders' legal responsibility for the debt of the business is limited to the amount they invested in the business.

Some clear advantages and disadvantages of forming this business organization:

- More difficult and costly to set up a corporation
- Because the corporation acts as a separate legal entity, the corporation has to file its own tax return. Lorraine will have to file a corporation tax return and still file her own tax return. This takes more time and becomes costly.
- The potential for higher taxes being paid but not in all cases (see below).
- Limited liability – under this option, Lorraine's personal assets are not at risk.
- Since Lorraine's business will be considered a Canadian controlled private corporation she will benefit from some lower tax rates. (This discussion is beyond the scope of this textbook.)

Both options above have several advantages and disadvantages. Lorraine should be aware of all these before deciding which option is best, however she must understand that setting up a corporation compared to a sole proprietorship reduces her risk of losing her personal assets in the event of something horribly going wrong with her business.

Remember, Lorraine is selling baked goods. If someone was to become ill from these goods and attempt to sue Lorraine, she could lose everything she owns if it is not properly protected.

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Setting up a corporation will reduce the chance of this happening and given what she is selling (i.e., baked goods), a food product, this would be the preferred option.

A partnership is not an option as Lorraine is going into business on her own. A partnership requires at least two individuals.

Unethical Issues:

It is very important to address the unethical statement that Lorraine's friend Christina mentioned that "The government knows that sole proprietorship owners omit some revenue earned from their business, but the government is fine with it and never bothers the owners about this."

It would be unethical to do so. Regardless of which business organization Lorraine decides to set up, it is important to make sure all business related transactions are captured in the financial statements of the business and all numbers reported to the government are accurate.

Integrity and credibility of Lorraine's business is important not only in the goods that she bakes but also in the reporting of her financial statements to Canada Revenue Agency (CRA) for tax reporting purposes.

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