TT TEXTBOOK TESTBANKS

Solutions Manual for Survey of Accounting 10th Warren

SOLUTIONS MANUAL SAMPLE PREVIEW

PUBLISHER
Cengage

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2024

RESOURCE TYPE
Solutions Manual

ISBN
9780357900291

CHAPTER 2
BASIC ACCOUNTING SYSTEMS: CASH BASIS

CLASS DISCUSSION QUESTIONS

1. The basic elements of a financial accounting system include the following: (1) a set of rules for determining what, when, and how much should be recorded; (2) a framework for preparing financial statements; and (3) one or more controls to determine whether errors may have occurred in the recording process. These elements apply to all businesses, from a local restaurant to Alphabet, Inc. All businesses require a financial reporting system so financial statements can be provided to stakeholders.

2. **a.** Purchase of land for cash affects only assets.

b. Payment of a liability affects assets and liabilities; receipt of cash for fees earned affects assets and stockholders' equity.

c. Incurring an expense partially paid in cash decreases assets increases liabilities and decreases stockholders' equity (retained earnings). For example, assume a business hires a lawyer for $10,000 to draft and file the necessary documents to start and incorporate the business. The business pays the lawyer $4,000 and agrees to pay the remaining $6,000 over the next several months. This transaction would decrease assets $(4,000), increase liabilities $6,000, and decrease stockholders' equity (retained earnings) $(10,000). The expense is an organizational expense. Likewise, a new business might hire a new chief operating officer by agreeing to pay a nonrefundable, noncancellable signing bonus of $50,000, with $30,000 due at signing and the remainder due in four installments. This transaction would decrease assets $(30,000), increase liabilities $20,000, and decrease stockholders' equity (retained earnings) $(50,000). The expense is salary expense or bonus expense.

3. Out of balance. Assets are correct, but retained earnings (utilities expense) should have been decreased by $1,200 rather than $2,100. Thus, retained earnings is understated by $900, and total liabilities plus stockholders' equity would be less than total assets by $900.

4. **a.** Out of balance. Assets are overstated by $27,000 ($85,000 – $58,000), and thus, total assets would exceed total liabilities plus stockholders' equity by $27,000.

b. In balance. Even though liabilities and stockholders' equity are incorrect, the accounting equation balances. For this error, liabilities are overstated by $7,000, and retained earnings (fees earned) are understated by $7,000; thus, the over- and understatements offset each other, and the accounting equation balances.

5. A primary control for determining the accuracy of record keeping is the equality of the accounting equation. The accounting equation must balance.

6. Total assets are increased by $175,000: an increase in cash of $375,000 and a decrease in land of $200,000. Stockholders' equity (retained earnings) is increased by $175,000, the gain on the sale of the land.

7. **a.** The payment of $15,000 of dividends decreases total assets (decrease in cash) and decreases stockholders' equity (decrease in retained earnings). Liabilities are not affected.

b. Net income is not affected by the payment of dividends. Dividends are a distribution of income to stockholders and are not an expense.

CLASS DISCUSSION QUESTIONS (Continued)

8. **a.** The equality of the accounting equation would not be affected. That is, the accounting equation would still balance.

   b. On the income statement, total operating expenses (salary expense) would be overstated by \$30,000, and net income would be understated by \$30,000. On the statement of stockholders' equity, the beginning and ending retained earnings would be correct. However, net income and dividends would be understated by \$30,000. These understatements offset one another, and thus, ending retained earnings is correct. The balance sheet is not affected by the error. On the statement of cash flows, net cash flows from operating activities is understated since cash paid for salary expense is overstated. In addition, net cash flows from financing activities is overstated since cash paid for dividends is understated. The understatement of net cash flows from operating activities is offset by the overstatement of net cash flows from financing activities, and thus, the net increase or decrease in cash for the period is correct as is the ending cash balance.

9. **a.** The equality of the accounting equation would not be affected. That is, the accounting equation would still balance.

   b. On the income statement, revenues (fees earned) would be overstated by \$75,000, and net income would be overstated by \$75,000. On the statement of stockholders' equity, the beginning retained earnings would be correct. However, net income and ending retained earnings would be overstated by \$75,000. The total assets reported on the balance sheet is correct. However, liabilities (notes payable) are understated by \$75,000, and stockholders' equity (retained earnings) is overstated by \$75,000. The understatement of liabilities is offset by the overstatement of stockholders' equity, and thus, total liabilities and stockholders' equity are correct. On the statement of cash flows, net cash flows from operating activities is overstated since cash received from fees earned is overstated. In addition, net cash flows from financing activities is understated, since cash received from borrowing (notes payable) is understated. The overstatement of net cash flows from operating activities is offset by the understatement of net cash flows from financing activities, and thus, the net increase or decrease in cash for the period is correct, as is the ending cash balance.

10. **a.** \$350,000 (\$500,000 – \$150,000)

    b.

Stockholders' equity as of December 31, 20Y8	\$400,000
Less stockholders' equity as of January 1, 20Y8	(350,000)
Net income	\$ 50,000

11.

Change in stockholders' equity (see Question 10)	\$ 50,000
Plus dividends	18,000
Net income	\$ 68,000

EXERCISES

E2–1

a. $988,700 ($387,200 + $601,500)

b. $$55,000 ($310,000 – $255,000)

c. $32,275 ($45,900 – $13,625)

E2–2

a. $52,832 ($98,598 – $45,766)

b. $54,329 increase ($95,386 – $41,057)

c. Total assets = $193,984 ($98,598 + $95,386)
Total liabilities = $100,095 ($45,766 + $54,329)
Total stockholders' equity = $93,889 ($52,832 + $41,057)

d. Yes. [$193,984 (total assets) = $100,095 (total liabilities) + $93,889 (total stockholders' equity)]

E2–3

(Amounts in millions)

a. $2,929 ($12,732 – $9,803)

b. $585 increase ($638 – $1,223)

c. Total assets = $12,094 ($12,732 – $638)
Total liabilities = $8,580 ($9,803 – $1,223)
Total stockholders' equity = $3,514 ($2,929 + $585)

d. Yes. [$12,094 (total assets) = $8,580 (total liabilities) + $3,514 (total stockholders' equity)]

E2–4

(a) $317,275 ($287,912 + $29,363)

(b) $98,613 ($415,888 – $317,275)

(c) $384,774 ($415,888 – $31,114)

(d) $96,862 [($384,774 – $287,912) or ($98,613 – $1,751)]

(e) $316,481 [($366,596 – $50,115) or ($247,209 + $69,272)]

(f) $247,209 [($283,396 – $36,187) or ($316,481 – $69,272)]

(g) $50,115 [($366,596 – $316,481) or ($36,187 + $13,928)]

(h) $13,928 [($83,200 – $69,272) or ($50,115 – $36,187)]

(i) $283,396 ($366,596 – $83,200)

E2–5

a. $825,000 ($1,200,000 – $375,000)

b. $895,000 ($825,000 + $150,000 – $80,000)

c. $525,000 ($825,000 – $200,000 – $100,000)

d. $1,300,000 ($825,000 + $400,000 + $75,000)

e. $160,000 net income ($1,275,000 – $290,000 – $825,000)

E2–6

a. (3) No effect
b. (3) No effect
c. (1) Increase
d. (3) No effect
e. (2) Decrease
f. (2) Decrease
g. (2) Decrease
h. (1) Increase
i. (1) Increase
j. (2) Decrease

E2–7

a. Increases assets and increases stockholders’ equity.

b. Decreases assets and decreases stockholders’ equity.

c. Increases assets and increases liabilities.

d. Increases assets and increases stockholders’ equity.

e. Increases assets and decreases assets.

E2–8

1. Total assets decreased $140,000.
2. Total liabilities decreased $300,000.
3. Stockholders’ equity increased $160,000.

E2–9

1. (a) increase
2. (a) increase
3. (b) decrease
4. (b) decrease
5. (b) decrease

E2–10

1. (c)
2. (e)
3. (e)
4. (c)
5. (b)
6. (a)
7. (e)
8. (e)
9. (e)

E2–11

a. (1) Provided catering services for cash, $28,000.
   (2) Purchased land for cash, $20,000.
   (3) Paid expenses, $18,000.
   (4) Paid cash as dividends, $1,000.

b. $11,000 ($40,000 – $29,000)

c. $9,000 ($109,000 – $100,000)

d. $10,000 ($28,000 – $18,000)

e. $9,000 ($10,000 – $1,000)

f. $10,000 ($28,000 – $18,000) from operating activities

g. $20,000 used for purchase of land

h. $1,000 used for payment of dividends

E2–12

It would be incorrect to say the business incurred a net loss of $10,000. The excess of the dividends over the net income for the period is a decrease in the amount of retained earnings in the corporation.

E2–13

Company Sierra

Stockholders' equity at end of year ($770,000 – $294,000)	$ 476,000
Deduct stockholders' equity at beginning of year ($490,000 – $175,000)	(315,000)
Net income (increase in stockholders' equity)	$ 161,000

Company Tango

Increase in stockholders' equity (as determined for Sierra)	$ 161,000
Add dividends	55,000
Net income	$ 216,000

Company Yankee

Increase in stockholders' equity (as determined for Sierra)	$ 161,000
Deduct issuance of additional common stock	(75,000)
Net income	$ 86,000

Company Zulu

Increase in stockholders' equity (as determined for Sierra)	$ 161,000
Deduct issuance of additional common stock	(75,000)
Add dividends	55,000
Net income	$ 141,000

E2–14

In each case, solve for a single unknown, using the following equation:

Stockholders' Equity (beginning) + Issuance of Common Stock – Dividends + Revenues – Expenses = Stockholders' Equity (ending)

Carbon:	Stockholders' equity at end of year ($480,000 – $165,000) ...		$ 315,000
	Deduct stockholders' equity at beginning of year ($340,000 – $122,000) ...		(218,000)
	Increase in stockholders' equity ...		$ 97,000
	Deduct increase due to net income ($110,000 – $45,000) ...		(65,000)
	Add dividends ...		7,500
	Additional issuance of common stock ...	(a)	$ 39,500
Krypton:	Stockholders' equity at end of year ($370,000 – $120,000) ...		$ 250,000
	Deduct stockholders' equity at beginning of year ($275,000 – $160,000) ...		(115,000)
	Increase in stockholders' equity ...		$ 135,000
	Add dividends ...		18,000
	Deduct additional issuance of common stock ...		(50,000)
	Increase due to net income ...		$ 103,000
	Add expenses ...		94,000
	Revenue ...	(b)	$ 197,000
Fluorine:	Stockholders' equity at end of year ($100,000 – $85,000) ...		$ 15,000
	Deduct stockholders' equity at beginning of year ($110,000 – $88,000) ...		(22,000)
	Decrease in stockholders' equity ...		$ (7,000)
	Add decrease due to net loss ($110,000 – $115,500) ...		5,500
	Deduct additional issuance of common stock ...		(12,000)
	Dividends ...	(c)	$ (13,500)
Radium:	Stockholders' equity at end of year ($242,000 – $134,000) ...		$ 108,000
	Add decrease due to net loss ($102,000 – $120,000) ...		18,000
	Add dividends ...		50,000
	Deduct additional issuance of common stock ...		(30,000)
	Stockholders' equity at beginning of year ...		$ 146,000
	Add liabilities at beginning of year ...		110,000
	Assets at beginning of year ...	(d)	$ 256,000

E2–15

(Amounts in millions)

a. **$123.4 = $(1,002.3) – $(1,125.7) = $(1,002.3) + $1,125.7**

b. **$212.5 = $632.7 + $52.6 + Net Cash Flows from (Used for) Financing Activities**

Net Cash Flows from (Used for) Financing Activities = $212.5 – $52.6 – $632.7

Net Cash Flows Used for Financing Activities = $(472.8)

E2–16

a.

ABBY'S INTERIORS Balance Sheet October 31, 20Y6		
Assets		
Cash		$ 50,000
Land		500,000
Total assets		$550,000
Liabilities		
Notes payable		$200,000
Stockholders' Equity		
Common stock	$ 75,000	
Retained earnings	275,000*	
Total stockholders' equity		350,000
Total liabilities and stockholders' equity		$550,000

*$550,000 – $200,000 – $75,000 = $275,000

E2–16, Concluded

ABBY'S INTERIORS Balance Sheet November 30, 20Y6		
Assets		
Cash		$ 175,000
Land		575,000
Total assets		$ 750,000
Liabilities		
Notes payable		$ 250,000
Stockholders' Equity		
Common stock	$ 90,000	
Retained earnings	410,000*	
Total stockholders' equity		500,000
Total liabilities and stockholders' equity		$ 750,000

*$750,000 – $250,000 – $90,000 = $410,000

b.	Retained earnings, November 30, 20Y6	$ 410,000
	Less retained earnings, October 31, 20Y6	(275,000)
	Increase in retained earnings	$ 135,000
	Add dividends	12,000
	Net income	$ 147,000

c. Net cash flows from operating activities = $147,000 (The same as net income using the cash basis.)

d. $(75,000) used for the increase in the land (Net cash flows used for investing activities equal the change in the land account.)

e. $53,000 (Net cash flows from financing activities equal the increase in common stock of $15,000 plus the increase in notes payable of $50,000 minus the dividends paid of $12,000.)

f. $125,000 [($175,000 – $50,000) or ($147,000 – $75,000 + $53,000)]

E2–17

WEST COAST DREAMS REALTY INC. Income Statement For the Month Ended June 30, 20Y9		
Revenues:		
Sales commissions		$165,000
Expenses:		
Salaries expense	$105,000	
Utilities expense	22,000	
Rent expense	14,000	
Interest expense	800	
Miscellaneous expense	4,100	
Total expenses		(145,900)
Net income		$ 19,100

E2–18

WEST COAST DREAMS REALTY INC. Statement of Stockholders' Equity For the Month Ended June 30, 20Y9	Common Stock	Retained Earnings	Total
Balances, June 1, 20Y9	$ 0	$ 0	$ 0
Issued common stock	180,000		180,000
Net income		19,100	19,100
Dividends		(2,100)	(2,100)
Balances, June 30, 20Y9	$180,000	$17,000	$197,000

E2–19

WEST COAST DREAMS REALTY INC. Balance Sheet June 30, 20Y9		
Assets		
Cash		$ 82,000
Land		210,000
Total assets		$292,000
Liabilities		
Notes payable		$ 95,000
Stockholders' Equity		
Common stock	$180,000	
Retained earnings	17,000	
Total stockholders' equity		197,000
Total liabilities and stockholders' equity		$292,000

E2–20

WEST COAST DREAMS REALTY INC. Statement of Cash Flows For the Month Ended June 30, 20Y9		
Cash flows from (used for) operating activities:		
Cash received from operating activities	$165,000	
Cash paid for operating activities	(145,900)	
Net cash flows from operating activities		$ 19,100
Cash flows from (used for) investing activities:		
Cash paid for land		(210,000)
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$180,000	
Cash received from issuing notes payable	95,000	
Cash paid as dividends	(2,100)	
Net cash flows from financing activities		272,900
Net increase in cash during June		$ 82,000
Cash as of June 1, 20Y9		0
Cash as of June 30, 20Y9		$ 82,000

E2–21

a. Decrease in assets and decrease in stockholders' equity.

b. Increase in assets and decrease in assets.

c. Increase in assets and increase in stockholders' equity.

d. Increase in assets and increase in liabilities.

e. Increase in assets and increase in stockholders' equity.

f. Decrease in assets and decrease in stockholders' equity.

g. Decrease in assets and decrease in stockholders' equity.

h. Increase in assets and decrease in assets.

i. Decrease in assets and decrease in stockholders' equity.

j. Decrease in assets and decrease in stockholders' equity.

k. Decrease in assets and decrease in liabilities.

l. Decrease in assets and decrease in stockholders' equity.

E2–22

a. operating activity
b. investing activity
c. financing activity
d. financing activity
e. operating activity
f. operating activity
g. operating activity
h. investing activity
i. operating activity
j. operating activity
k. financing activity
l. financing activity

PROBLEMS

P2–1

1.

Financial Statement Effects

	BALANCE SHEET							
	Assets			= Liabilities		+ Stockholders' Equity		
	Cash	+	Land	=	Notes Payable +	Common Stock	+	Retained Earnings
a. Issued common stock	30,000					30,000		
b. Issued note payable	50,000				50,000			
Balances	80,000				50,000	30,000		
c. Fees earned	15,000							15,000
Balances	95,000				50,000	30,000		15,000
d. Rent expense	(2,500)							(2,500)
Balances	92,500				50,000	30,000		12,500
e. Paid expenses	(1,750)							(1,750)
Balances	90,750				50,000	30,000		10,750
f. Paid salary expense	(3,250)							(3,250)
Balances	87,500				50,000	30,000		7,500
g. Paid interest expense	(250)							(250)
Balances	87,250				50,000	30,000		7,250
h. Purchased land	(60,000)		60,000					
Balances	27,250		60,000		50,000	30,000		7,250
i. Paid dividends	(1,500)							(1,500)
Balances, March 31	25,750		60,000		50,000	30,000		5,750

STATEMENT OF CASH FLOWS

a.	Financing	30,000
b.	Financing	50,000
c.	Operating	15,000
d.	Operating	(2,500)
e.	Operating	(1,750)
f.	Operating	(3,250)
g.	Operating	(250)
h.	Investing	(60,000)
i.	Financing	(1,500)
	Increase in cash	25,750

INCOME STATEMENT

c.	Fees earned	15,000
d.	Rent expense	(2,500)
e.	Auto expense	(1,250)
e.	Misc. expense	(500)
f.	Salary expense	(3,250)
g.	Interest expense	(250)
	Net income	7,250

2. **Stockholders' equity is the right of stockholders to the assets of the business. These rights are increased by stockholders' investments and revenues and decreased by dividends and expenses.**

P2–1, Continued

3.

SMITH INSURANCE INC. Income Statement For the Month Ended July 31, 20Y5		
Revenues:		
Fees earned		$15,000
Expenses:		
Salary expense	$3,250	
Rent expense	2,500	
Auto expense	1,250	
Interest expense	250	
Miscellaneous expense	500	
Total expenses		(7,750)
Net income		$ 7,250

SMITH INSURANCE INC. Statement of Stockholders' Equity For the Month Ended July 31, 20Y5	Common Stock	Retained Earnings	Total
Balances, July 1, 20Y5	$ 0	$ 0	$ 0
Issued common stock	30,000		30,000
Net income		7,250	7,250
Dividends		(1,500)	(1,500)
Balances, July 31, 20Y5	$30,000	$ 5,750	$35,750

4.

SMITH INSURANCE INC. Balance Sheet July 31, 20Y5		
Assets		
Cash		$25,750
Land		60,000
Total assets		$85,750
Liabilities		
Notes payable		$50,000
Stockholders' Equity		
Common stock	$30,000	
Retained earnings	5,750	
Total stockholders' equity		35,750
Total liabilities and stockholders' equity		$85,750

P2–1, Concluded

5.

SMITH INSURANCE INC.
Statement of Cash Flows
For the Month Ended July 31, 20Y5

Cash flows from (used for) operating activities:		
Cash received from operating activities	$15,000	
Cash paid for operating activities	(7,750)	
Net cash flows from operating activities		$ 7,250
Cash flows from (used for) investing activities:		
Cash paid for land		(60,000)
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$30,000	
Cash received from issuing note payable	50,000	
Cash paid as dividends	(1,500)	
Net cash flows from financing activities		78,500
Net increase in cash during July		$ 25,750
Cash as of July 1, 20Y5		0
Cash as of July 31, 20Y5		$ 25,750

P2–2

1.

RESTART TECHNOLOGY SERVICES Income Statement For the Month Ended August 31, 20Y4		
Fees earned		$54,000
Operating expenses:		
Salaries expense	$9,200	
Rent expense	5,000	
Automobile expense	2,400	
Miscellaneous expense	1,400	
Total operating expenses		(18,000)
Net income		$36,000

2.

RESTART TECHNOLOGY SERVICES Statement of Stockholders' Equity For the Month Ended August 31, 20Y4	Common Stock	Retained Earnings	Total
Balances, Aug. 1, 20Y4	$ 0	$ 0	$ 0
Issued common stock	50,000		50,000
Net income		36,000	36,000
Dividends		(6,000)	(6,000)
Balances, Aug. 31, 20Y4	$50,000	$30,000	$80,000

3.

RESTART TECHNOLOGY SERVICES Balance Sheet August 31, 20Y4		
Assets		
Cash		$ 20,000
Land		80,000
Total assets		$100,000
Liabilities		
Notes payable		$ 20,000
Stockholders' Equity		
Common stock	$50,000	
Retained earnings	30,000	
Total stockholders' equity		80,000
Total liabilities and stockholders' equity		$100,000

P2–2, Concluded

4.

RESTART TECHNOLOGY SERVICES Statement of Cash Flows For the Month Ended August 31, 20Y4		
Cash flows from (used for) operating activities:		
Cash received from operating activities	$54,000	
Cash paid for operating activities	(18,000)	
Net cash flows from operating activities		$ 36,000
Cash flows from (used for) investing activities:		
Cash paid for land		(80,000)
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$50,000	
Cash received from issuing notes payable	20,000	
Cash paid as dividends	(6,000)	
Net cash flows from financing activities		64,000
Net increase in cash during August		$ 20,000
Cash as of August 1, 20Y4		0
Cash as of August 31, 20Y4		$ 20,000

P2–3

1.

DUST, SWEEP, REPEAT SERVICES, INC. Income Statement For the Year Ended December 31, 20Y7		
Revenues:		
Fees earned		$132,000
Expenses:		
Salaries expense	$56,400	
Utilities expense	24,000	
Rent expense	15,000	
Taxes expense	8,300	
Interest expense	1,080	
Miscellaneous expense	3,020	
Total expenses		(107,800)
Net income		$ 24,200

2.

DUST, SWEEP, REPEAT SERVICES, INC. Statement of Stockholders' Equity For the Year Ended December 31, 20Y7	Common Stock	Retained Earnings	Total
Balances, Jan. 1, 20Y7	$ 0	$ 0	$ 0
Issued common stock	12,000		12,000
Net income		24,200	24,200
Dividends		(2,200)	(2,200)
Balances, Dec. 31, 20Y7	$12,000	$22,000	$34,000

P2–3, Concluded

3.

DUST, SWEEP, REPEAT SERVICES, INC. Balance Sheet December 31, 20Y7		
Assets		
Cash		$10,000
Land		42,000
Total assets		$52,000
Liabilities		
Notes payable		$18,000
Stockholders' Equity		
Common stock	$12,000	
Retained earnings	22,000	
Total stockholders' equity		34,000
Total liabilities and stockholders' equity		$52,000

4.

DUST, SWEEP, REPEAT SERVICES, INC. Statement of Cash Flows For the Year Ended December 31, 20Y7		
Cash flows from (used for) operating activities:		
Cash received from operating activities	$132,000	
Cash paid for operating activities	(107,800)	
Net cash flows from operating activities		$ 24,200
Cash flows from (used for) investing activities:		
Cash paid for land		(42,000)
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$ 12,000	
Cash received from issuing notes payable	18,000	
Cash paid as dividends	(2,200)	
Net cash flows from financing activities		27,800
Net increase in cash during the year		$ 10,000
Cash as of January 1, 20Y7		0
Cash as of December 31, 20Y7		$ 10,000

P2–4

1.

DUST, SWEEP, REPEAT SERVICES, INC. Income Statement For the Year Ended December 31, 20Y8		
Revenues:		
Fees earned		$ 450,000
Expenses:		
Salaries expense	$202,000	
Utilities expense	65,000	
Rent expense	53,000	
Taxes expense	23,000	
Interest expense	4,800	
Miscellaneous expense	15,200	
Total expenses		(363,000)
Net income		$ 87,000

2.

DUST, SWEEP, REPEAT SERVICES, INC. Statement of Stockholders' Equity For the Year Ended December 31, 20Y8	Common Stock	Retained Earnings	Total
Balances, Jan. 1, 20Y8	$12,000	$ 22,000	$ 34,000
Issued common stock	48,000*		48,000
Net income		87,000	87,000
Dividends		(10,000)	(10,000)
Balances, Dec. 31, 20Y8	$60,000	$ 99,000	$159,000

*$60,000 – $12,000 = $48,000

P2–4, Concluded

3.

DUST, SWEEP, REPEAT SERVICES, INC.
Balance Sheet
December 31, 20Y8

Assets		
Cash		$ 79,000*
Land		160,000
Total assets		$239,000
Liabilities		
Notes payable		$ 80,000
Stockholders' Equity		
Common stock	$60,000	
Retained earnings	99,000	
Total stockholders' equity		159,000
Total liabilities and stockholders' equity		$239,000

*$239,000 – $160,000 = $79,000

4.

DUST, SWEEP, REPEAT SERVICES, INC.
Statement of Cash Flows
For the Year Ended December 31, 20Y8

Cash flows from (used for) operating activities:		
Cash received from operating activities	$ 450,000	
Cash paid for operating activities	(363,000)	
Net cash flows from operating activities		$ 87,000
Cash flows from (used for) investing activities:		
Cash paid for land		(118,000)*
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$ 48,000**	
Cash received from issuing notes payable	62,000***	
Cash paid for dividends	(10,000)	
Net cash flows from financing activities		100,000
Net increase in cash during the year		$ 69,000
Cash as of Jan. 1, 20Y8		10,000
Cash as of Dec. 31, 20Y8		$ 79,000

*$160,000 – $42,000 = $118,000

**$60,000 – $12,000 = $48,000

***$80,000 – $18,000 = $62,000

P2–5

a. $125,000 (Net income for December of $57,500 plus total operating expenses of $67,500; also, the amount of cash received from customers on the statement of cash flows.)

b. $10,620 ($67,500 – $33,120 – $18,000 – $1,800 – $3,960)

c. $57,500 ($125,000 – $67,500); also, see the net income for December on the statement of stockholders' equity.

d. $0 (There is no beginning retained earnings since December was the first month of operations.)

e. $12,000 (See the cash dividends on the statement of cash flows.)

f. $45,500 ($57,500 – $12,000)

g. $120,500 ($75,000 + $45,500) or ($0 + $75,000 + $57,500 – $12,000)

h. $50,500 ($225,500 – $175,000)

i. $75,000 (See the cash received from common stock on the statement of cash flows or the ending balance of common stock on the statement of stockholders' equity.)

j. $45,500 (the same as f)

k. $120,500 ($75,000 + $45,500) or (i + j) or the same as g

l. $225,500 ($105,000 + $120,500); also the same as total assets.

m. $57,500 ($125,000 – $67,500) or the same as c

n. $105,000 (See notes payable on the balance sheet.)

o. $168,000 ($75,000 + $105,000 – $12,000)

p. $50,500 ($57,500 – $175,000 + $168,000)

q. $0 (December was the first month of operations.)

r. $50,500 ($50,500 + $0) or the same as h

P2–6

1. a. All financial statements should contain the name of the business in their heading. The statement of stockholders' equity is incorrectly headed as "Angela Griffin" rather than Alpine Realty, Inc. The heading of the balance sheet needs the name of the business.

   b. The income statement, statement of stockholders' equity, and statement of cash flows cover a period of time and should be labeled "For the Month Ended July 31, 20Y8."

   c. The year in the heading for the statement of stockholders' equity should be 20Y8 rather than 20Y7.

   d. The balance sheet should be labeled as of "July 31, 20Y8," rather than "For the Month Ended July 31, 20Y7."

   e. On the income statement, the dividends should not be listed as an operating expense but should be included in the statement of stockholders' equity.

   f. On the income statement, the total operating expenses include dividends of $2,000, resulting in an incorrect net income amount. This also affects the statement of stockholders' equity.

   g. On the statement of stockholders' equity, a column for common stock should be included along with a total column. In addition, dividends should be subtracted from net income to arrive at retained earnings as of July 31, 20Y8.

   h. Notes payable should be listed as a liability on the balance sheet.

   i. Land should be listed as an asset on the balance sheet.

   j. The balance sheet assets should equal the sum of the liabilities and stockholders' equity.

   k. The cash payments for operating expenses have been omitted from the operating activities section of the statement of cash flows.

   l. The cash flows from financing activities should not include retained earnings. In addition, the financing activities section should include cash received from issuing common stock and notes payable. Also, the cash paid as dividends should be included as a deduction to arrive at net cash flows from financing activities.

P2–6, Continued

m. Since this is Alpine Realty's first month of operations, the net increase in cash for July on the statement of cash flows should equal $32,000, the cash balance as of July 31, 20Y8.

2. Corrected financial statements appear as follows:

ALPINE REALTY, INC.
Income Statement
For the Month Ended July 31, 20Y8

Sales commissions		$60,000
Expenses:		
Office salaries expense	$20,000	
Rent expense	6,000	
Automobile expense	3,500	
Miscellaneous expense	1,500	
Total operating expenses		(31,000)
Net income		$29,000

ALPINE REALTY, INC.
Statement of Stockholders' Equity
For the Month Ended July 31, 20Y8

	Common Stock	Retained Earnings	Total
Balances, July 1, 20Y8	$ 0	$ 0	$ 0
Issued common stock	15,000		15,000
Net income		29,000	29,000
Dividends		(2,000)	(2,000)
Balances, July 31, 20Y8	$15,000	$27,000	$42,000

P2–6, Concluded

ALPINE REALTY, INC. Balance Sheet July 31, 20Y8		
Assets		
Cash		$32,000
Land		30,000
Total assets		$62,000
Liabilities		
Notes payable		$20,000
Stockholders' Equity		
Common stock	$15,000	
Retained earnings	27,000	
Total stockholders' equity		42,000
Total liabilities and stockholders' equity		$62,000

ALPINE REALTY, INC. Statement of Cash Flows For the Month Ended July 31, 20Y8		
Cash flows from (used for) operating activities:		
Cash received from sales commissions	$ 60,000	
Cash paid for operating expenses	(31,000)	
Net cash flows from operating activities		$ 29,000
Cash flows from (used for) investing activities:		
Cash paid for land		(30,000)
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$ 15,000	
Cash received from issuing notes payable	20,000	
Cash paid as dividends	(2,000)	
Net cash flows from financing activities		33,000
Net increase in cash during July		$ 32,000
Cash as of July 1, 20Y8		0
Cash as of July 31, 20Y8		$ 32,000

METRIC-BASED ANALYSIS

MBA 2–1

Transaction Metric Effects

LIQUIDITY		PROFITABILITY	
Cash		**Net Income—Cash Basis**	
a. Issued stock	30,000	a. No Effect	—
b. Issued note pay.	50,000	b. No Effect	—
c. Earned fees	15,000	c. Increase	15,000
d. Paid rent expense	(2,500)	d. Decrease	(2,500)
e. Paid expenses	(1,750)	e. Decrease	(1,750)
f. Paid salaries	(3,250)	f. Decrease	(3,250)
g. Paid interest	(250)	g. Decrease	(250)
h. Purchased land	(60,000)	h. No Effect	—
i. Paid dividends	(1,500)	i. No Effect	—
Total	25,750		7,250

MBA 2–2

Transaction Metric Effects

LIQUIDITY		PROFITABILITY	
Cash		**Net Income—Cash Basis**	
a. Issued stock	50,000	a. No Effect	—
b. Earned fees	54,000	b. Increase	54,000
c. Paid rent expense	(5,000)	c. Decrease	(5,000)
d. Issued note pay.	20,000	d. No Effect	—
e. Purchased land	(80,000)	e. No Effect	—
f. Paid expenses	(3,800)	f. Decrease	(3,800)
g. Paid salaries	(9,200)	g. Decrease	(9,200)
h. Paid dividends	(6,000)	h. No Effect	—
Total	20,000		36,000

MBA 2–3

1.

	Year 2	Year 1	Increase (Decrease)
Sales	100.0%	100.0%	n/a
Cost of goods sold	(67.8)	(65.7)	2.1%
Gross profit	32.2%	34.3%	(2.1)%
Selling and administrative expenses	(19.8)	(21.5)	(1.7)
Operating income	12.4%	12.8%	(0.4)%

2. Kellogg's operating income as a percent of sales decreased by (0.4)% from 12.8% to 12.4%. This decrease was caused by the increase in cost of goods sold of 2.1%, which was partially offset by the decrease in selling and administrative expenses of (1.7)%.

MBA 2–4

1.

	Year 2	Year 1	Increase (Decrease)
Sales	100.0%	100.0%	n/a
Cost of goods sold	(64.4)	(65.2)	(0.8)%
Gross profit	35.6%	34.8%	0.8%
Selling and administrative expenses	(17.0)	(17.9)	(0.9)
Operating income	18.6%	16.9%	1.7%

2. General Mills' operating income as a percent of sales increased by 1.7% from 16.9% to 18.6%. This increase was caused by the decrease in cost of goods sold of (0.8)% and the decrease in selling and administrative expenses of (0.9)%.

MBA 2–5

In Year 2, Kellogg's operating income as a percentage of sales decreased by (0.4)%; however, General Mills' income as a percentage of sales increased by 1.7%. This difference was caused by Kellogg's increase of 2.1% in cost of goods sold compared to General Mills' decrease of (0.8)% in cost of goods sold. In Year 2, Kellogg's selling and administrative expenses decreased by (1.7)% compared to General Mills' decrease of (0.9)%. Thus, General Mills' Year 2 operating performance has improved relative to Kellogg's operating performance.

MBA 2–6

1.

	Year 2	Year 1	Increase (Decrease)
Revenue	100.0%	100.0%	n/a
Operating expenses:			
Fuel	(18.8)%	(18.6)%	0.2%
Aircraft related	(27.9)	(43.9)	(16.0)
Selling and general	(43.8)	(67.8)	(24.0)
Other expenses	(3.2)	(42.6)	(39.4)
Total operating expenses	(93.7)%	(172.9)%	(79.2)%
Operating income	6.3%	(72.9)%	79.2%

2. Delta's operating income as a percent of revenue increased 79.2% from (72.9)% in Year 1 to 6.3% in Year 2. Aircraft-related expenses decreased (16.0)%, and selling and general expenses decreased (24.0)%. There was a small increase of 0.2% related to fuel costs. Overall, these decreases were due to lower volume-related (variable) costs related to airplanes that were not flying, cost-cutting restructuring efforts, and recognition of pandemic-related government grants.

MBA 2–7

1.

	Year 2	Year 1	Increase (Decrease)
Revenue	100.0%	100.0%	n/a
Operating expenses:			
Cost of goods sold	(37.9)%	(20.4)%	17.5%
Selling and general	(15.6)	(27.8)	(12.2)
Other expenses	(16.6)	(34.9)	(18.3)
Total operating expenses	(70.1)%	(83.1)%	(13.0)%
Operating income	29.9%	16.9%	13.0%

Note: Small differences in percentages are due to rounding.

2. Pfizer's operating income increased 13.0% as a percent of revenue from 16.9% in Year 1 to 29.9% in Year 2. The increase was caused primarily by a decrease of (12.2)% in selling and general expenses, and a decrease in other expenses of (18.3)%. This was partially offset by an increase in cost of goods sold of 17.5%.

MBA 2–8

Pfizer's operating income as a percent of revenue increased by 13.0% compared to Delta's increase of 79.2%. The difference in operating results appears to be attributable to the impact of the economic recovery related to the COVID-19 pandemic. Pfizer's increase in revenues and operating income was largely due to the release of it's COVID-19 vaccine. Delta's large increase in operating income was the result of an increase in revenue due to the recovery of the industry from the COVID-19 pandemic, coupled with a percentage decrease in selling and general and other costs. These costs are largely fixed costs (as opposed to fuel costs that are largely variable) and could not be avoided when air travel was interrupted.

MBA 2–9

1.

	Year 2	Year 1	Increase (Decrease)
Current assets:			
Cash	10.0%	11.7%	(1.7)%
Marketable securities	7.9	16.3	(8.4)
Accounts receivable	7.5	5.0	2.5
Inventories	1.9	1.3	0.6
Other	11.2	10.1	1.1
Total current assets	38.4%	44.4%	(6.0)%
Long-term assets:			
Long-term marketable securities	36.4%	31.1%	5.3%
Property, plant, and equipment	11.2	11.4	(0.2)
Other long-term assets	13.9	13.1	0.8
Total long-term assets	61.6%	55.6%	6.0%
Total assets	100.0%	100.0%	n/a
Current liabilities:			
Accounts payable	15.6%	13.1%	2.5%
Current portion of long-term debt	4.4	4.2	0.2
Other	15.7	15.2	0.5
Total current liabilities	35.7%	32.5%	3.2%
Long-term liabilities	46.3	47.3	(1.0)
Total liabilities	82.0%	79.8%	2.2%
Stockholders' equity:			
Common stock	16.3%	15.7%	0.6%
Retained earnings	1.6	4.6	(3.0)
Other items	0.1	(0.1)	0.2
Total stockholders' equity	18.0%	20.2%	(2.2)%
Total liabilities and stockholders' equity	100.0%	100.0%	n/a

Note: Small differences in percentages are due to rounding.

2. Apple's current assets as a percent of total assets decreased by 6.0% from 44.4% to 38.4% with marketable securities decreasing the most by 8.4%. At the same time, long-term assets increased by 6.0%. Apple's total liabilities increased by 2.2% from 79.8% to 82.0% with accounts payable increasing the most by 2.5%.

CASES

Case 2–1

1. From the Business Insight in Chapter 1, the two possible business emphases that could be used are low-cost emphasis and premium-price emphasis.

2. Real-world examples of each emphasis are as follows:

   Low-cost emphasis: SteinMart, Walmart, Kmart, Costco
   Premium-price emphasis: GAP, The Limited, Talbots

3. The answers will vary among the student groups. Normally, venture capital firms demand a large percentage of ownership, which may be the majority (over 50%) ownership.

Case 2–2

Dr. Turner's comment is not correct. The difference in the cash balance of $55,000 ($100,000 – $45,000) represents the net result of operating, investing, and financing cash activities. To determine the profit, the effects of Dr. Turner's investing and financing activities would also need to be considered. For example, Dr. Turner might have invested in buildings, land, computer equipment, or software programs that would be classified as investing activities. Also, Dr. Turner may have borrowed cash from a bank or withdrawn cash from SickCo as dividends.

Case 2–3

	Year 1	Year 2	Year 3
Net cash flows from (used for) operating activities	negative	positive	positive
Net cash flows from (used for) investing activities	negative	negative	negative
Net cash flows from (used for) financing activities	positive	positive	negative

Start-up companies normally experience negative cash flows from operating and investing activities. Also, start-up companies normally have positive cash flows from financing activities from raising capital but that could become negative as they repay borrowings in future years.

Case 2–4

Note to Instructors: **Answers will vary based upon the date students do their research. The objective of this case is to familiarize students with financial reporting resources available on the Internet. The following solution is based upon the Apple Inc. data as of the close on May 4, 2022, from Yahoo.com's finance Web site.**

1. **$166.02 (See opening page for AAPL)**

2. **$122.25 to $182.94 (See opening page for AAPL)**

3. **$182.94 (See Statistics)**

4. **Yes, by several officers, including Deirdre O'Brien, Jeffrey Williams (Chief Operating Officer), Katherine Adams (General Counsel), and Arthur Levinson (Director). (See Insider Transactions under Holders)**

5. **Timothy D. Cook. (See Profile)**

6. **$16,390,000 (See Profile)**

7. **0.44 (See Statistics)**

8. **Strong Buy = 11**
   Buy = 21
   Hold = 6
   Sell = 0
   Strong Sell = 0

   1.9 where 1 is Strong Buy and 5 is Sell (See Analysis)

9. **$104,038 million (See Cash Flows under Financials)**

10. **30.93% (See Statistics)**

Instructor Manual

Warren, Survey of Accounting, 10e, 2024, 9780357900291; Chapter 2: Basic Accounting Systems: Cash Basis

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PURPOSE AND PERSPECTIVE OF THE CHAPTER

The purpose of Chapter 2 is to explore the basic elements of financial accounting systems. Such systems process, record, and summarize financial transactions, allowing for the preparation of financial statements, as discussed in Chapter 1. The simplest form of an accounting system records and summarizes only transactions involving the receipt and payment of cash. For this reason, this chapter describes and illustrates a cash basis accounting system. This serves as a foundation for later discussions of more complex accounting systems and financial reporting issues.

First, the text describes the basic elements of a financial accounting system: its rules, framework, and controls.

Next, it covers how to analyze, record, and summarize transactions for a corporation's first period of operations and then prepare financial statements for that same period. Then, it discusses how to perform the same activities for a corporation's second period of operations. The effects of these transactions on liquidity and profitability metrics are illustrated, with cash used as the liquidity metric and net income (revenues less expenses) as the profitability metric.

Finally, the text discusses and illustrates how common-sized income statements can be used to assess a company's performance.

CHAPTER OBJECTIVES

The following objectives are addressed in this chapter:

Obj. 1 Describe the basic elements of a financial accounting system.

Obj. 2 Analyze, record, and summarize transactions for a corporation's first period of operations.

Obj. 3 Prepare financial statements for a corporation's first period of operations.

Obj. 4 Analyze, record, and summarize transactions for a corporation's second period of operations.

Obj. 5 Prepare financial statements for a corporation's second period of operations.

Obj. 6 Describe and illustrate the use of common-sized income statements in assessing a company's performance.

List of Chapter Activities

The following table organizes activities and assessments in the PowerPoint by objective, so that you can see how all this content relates to objectives and make decisions about which content you would like to emphasize in your class based on your objectives. For additional activities, refer to the Teaching Online Guide and the Educator Guide.

Chapter Objective	Activity/Assessment	Source (i.e., PPT slide, Workbook)
Obj. 1	Knowledge Check Activity 1	PPT Slides 7–8
Obj. 2	Knowledge Check Activity 2	PPT Slides 22–23
Obj. 3	Knowledge Check Activity 3	PPT Slides 30–31
Obj. 5	Discussion Activity 1	PPT Slides 41–42
Obj. 6	Discussion Activity 2	PPT Slides 46–47

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Key Terms

Common-sized balance sheet: A balance sheet where each amount is expressed as a percent of total assets or total liabilities plus stockholders' equity.

Common-sized financial statements: Financial statements that express each amount as a percent of a base amount.

Common-sized income statement: An income statement where each amount is expressed as a percent of sales.

Financial accounting system: A system that includes (1) a set of rules for determining what, when, and the amount that should be recorded for an economic event; (2) a framework for facilitating preparing financial statements; and (3) one or more controls to determine whether errors could have occurred in the recording process.

Liquidity: Refers to the ability to convert an asset to cash.

Transaction: An economic event that, under generally accepted accounting principles (GAAP), affects an element of the accounting equation and must be recorded.

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What's New in This Chapter

The following elements are improvements in this chapter from the previous edition:

- A new Using Data Analytics feature entitled “Extracting Data” has been added.
- The financials of all exercises and problems involving real-world companies have been updated.
- Exercise E2-15 involving Oracle Corporation has been replaced with a new Exercise E2-15 involving Twitter, Inc.
- MBA 2-4 involving Southwest Airlines Co. has been replaced with a new MBA 2-7 involving Pfizer Inc.
- Case 2-3 involving Amazon.com has been replaced with a new Case 2-3 involving DoorDash, Inc.
- The following end-of-chapter items have also been revised with new financials: E2-1, E2-10, E2-12, E2-14, E2-17 through E2-20, P2-3, and P2-4.

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Chapter Outline

The following outline organizes activities (including any existing discussion questions in PowerPoints or other supplements) and assessments by chapter (and therefore by topic), so that you can see how all the content relates to the topics covered in the text.

I. Elements of an Accounting System (2-1, PPT Slides 3–8, BUSPROG: Analytic, AICPA: FN-Measurement)

   a. The rules of an accounting system are derived from accounting concepts, which are the basis of generally accepted accounting principles (GAAP). They also govern how transactions are to be recorded in an accounting system.
      - A **transaction** is an economic event that, under GAAP, affects the financial statements.
      - A transaction may affect one, two, or more items within the financial statements.

   b. Transactions must be analyzed, recorded, and summarized using a framework.
      - The accounting equation is the basis for frameworks.
      - It is expressed as follows: Assets = Liabilities + Stockholders’ Equity.

- Exhibit 1 (PPT Slide 5) illustrates an integrated financial statement framework.

c. The integrated financial statement approach has built-in controls to ensure that all transactions are correctly analyzed, recorded, and summarized.
- The accounting equation must balance.
- The ending cash on the statement of cash flows must equal the cash on the balance sheet.
- The net income on the income statement must equal the net effects of revenues and expenses on retained earnings.

d. **Knowledge Check Activity 1:** *When a company has net income, the retained earnings are increased by the difference between which of the following?* (PPT Slides 7–8)
- The answer is revenue and expenses.
- The net income on the income statement must equal the net effects of revenue and expenses on retained earnings.

II. Recording a Corporation's First Period of Operations (2-2, PPT Slides 9–23, BUSPROG: Analytic, AICPA: FN-Measurement)

a. The integrated financial statement framework shown in Exhibit 1 is illustrated using the transactions for a corporation's first period of operations.

- Transaction a: Investment to Establish Business
- Transaction b: Borrowing Money to Finance Operations
- Transaction c: Buying Land for Cash
- Transaction d: Fees Earned in Cash
- Transaction e: Expenses Paid in Cash
- Transaction f: Dividends Paid

b. Exhibit 2 (PPT Slide 16) illustrates the three controls that are built into the integrated financial statement approach.

c. The Balance Sheet column reflects the accounting equation; the two sides of the accounting equation are always equal.

d. Every transaction increases or decreases one or more of the balance sheet elements—assets, liabilities, or stockholders' equity.

e. A transaction may or may not affect an element of the statement of cash flows or the income statement.

f. Every cash transaction increases or decreases the asset (cash) on the balance sheet.

g. The ending balance of cash under the Statement of Cash Flows column equals the ending cash balance shown on the balance sheet.

h. The stockholders' equity is increased by amounts invested by stockholders (common stock).
i. Revenues increase stockholders' equity (retained earnings), and expenses decrease stockholders' equity (retained earnings). Stockholders' equity (retained earnings) is decreased by dividends paid to stockholders.
j. Change in retained earnings for the period is the net income minus dividends, or for a net loss, the net loss plus dividends.
k. The statement of cash flows is linked to the balance sheet through cash.
l. The income statement is linked to the balance sheet through revenues and expenses (net income or loss), which affects retained earnings.
m. Exhibit 3 (PPT Slide 20) summarizes the effects of the various transactions affecting stockholders' equity.
n. **Knowledge Check Activity 2:** *Stockholders' equity is decreased when a company does which of the following?* (PPT Slides 22–23)
    - The answer is pays dividends.
    - Activities that decrease stockholders' equity include paying dividends and incurring expenses.

III. Financial Statements for a Corporation's First Period of Operations (2-3, PPT Slides 24–31, BUSPROG: Analytic, AICPA: FN-Measurement)

a. The accounting reports that provide summarized information of the transactions are financial statements.
b. The financial statements for Family Health Care are prepared in the order shown in Exhibit 4 (PPT Slides 25–28).
c. Exhibit 5 (PPT Slide 29) shows how Family Health Care's financial statements for September are integrated.
d. **Knowledge Check Activity 3:** *Which of the financial statements shows the fees earned and the associated expenses to earn those fees?* (PPT Slides 30–31)
    - The answer is income statement.
    - The income statement lists the fees earned and the summarized expenses that occurred within the same reporting period.

IV. Recording a Corporation's Second Period of Operations (2-4, PPT Slides 32–34, BUSPROG: Analytic, AICPA: FN-Measurement)

a. Exhibit 6 (PPT Slide 33) shows Family Health Care's summary of transactions for October.

V. Financial Statements for a Corporation's Second Period of Operations (2-5, PPT Slides 35–42, BUSPROG: Analytic, AICPA: FN-Measurement)

a. Family Health Care's financial statements for October are shown in Exhibit 7 (PPT Slides 36–39).
    - The financial statements were prepared using Family Health Care's summary of transactions for October from Exhibit 6.

b. Exhibit 8 (PPT Slide 40) shows how Family Health Care's financial statements for October are integrated.

c. **Discussion Activity 1:** *Break class into small groups of 3 to 4 students.* (PPT Slides 41–42)
    - Financial statements can provide a lot of useful information to investors.
    - If an investor is most concerned with how and why a company's cash balance changed during an accounting period, which financial statement would be most helpful?
        - While the balance sheet shows the actual cash balance on the last day of a reporting period, it does not show the activities that caused the cash balance to change from the first to the last day of an accounting period.
        - The statement of cash flows provides a list of activities that affected the cash balance during the reporting period. It categorizes the type of activity into the areas of operating, investing, and financing activities. By looking at these activities, an investor can see if a company was able to cover most, if not all, of their operating expenses. An investor can also see if a company paid cash dividends; invested in new property, plant, and equipment; borrowed cash; or repaid debt.

VI. Metric-Based Analysis: Common-Sized Financial Statements (2-6, PPT Slides 43–47, BUSPROG: Analytic, AICPA: FN-Measurement)

a. Companies prepare common-sized financial statements to assess their financial condition and performance over time.

b. Common-sized financial statements are prepared by expressing financial statement amounts as a percent of a base amount.

c. A common-sized income statement is prepared by expressing income statement amounts as a percent of sales.

d. A common-sized balance sheet is prepared by expressing each asset as a percent of total assets.

e. Each liability and stockholders' equity item is expressed as a percent of total liabilities plus stockholders' equity.

f. **Discussion Activity 2:** *Break class into small groups of 3 to 4 students*. (PPT Slides 46–47)

- How are common-sized financial statements helpful to an investor?
  - Investors can use the common-sized financial statements to assess a company's financial condition and performance over time.
- What kind of information can an investor learn from a common-sized income statement?
  - In a common-sized income statement, an investor can see if the cost of goods sold as a percentage of sales has increased, decreased, or remained about the same over the past few years. This could forecast a potential reduction in gross profit if product costs become higher and sales either decrease or remain consistent. Similarly, an increase in operating expenses as a percentage of sales could also cause concern about a company's long-term profitability and solvency.

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Additional Discussion Questions

The following are discussion questions that do not appear in the text, PPTs, or courseware (if courseware exists)—they are for you to use as you wish. You can assign these questions several ways: in a discussion forum in your LMS; as whole-class discussions in person; or as a partner or group activity in class.

1. Discussion: The Importance of Integration (Elements of an Accounting System, 2-1, PPT Slide 5); Duration: 10 minutes.
   a. Why is it essential to analyze all of a company's financial statements and their integration?
      i. Answer: Without understanding how a company's financial statements are integrated, important trends or events may be missed or misinterpreted. To illustrate, assume a company reports net income (profits) on its income statement. As a result, it might be mistakenly concluded that the company's operations are doing well and no major changes are necessary. In fact, the company might be experiencing a continuing negative net cash

flow from operations and thus be headed toward bankruptcy. Therefore, it is essential to analyze all the financial statements and their integration.

2. Discussion: How Transactions Affect Financial Statements (Recording a Corporation's First Period of Operations, 2-2, PPT Slides 17–19); Duration: 10 minutes.
    a. Do all transactions affect an element of the statement of cash flows or the income statement?
        i. Answer: Every transaction affects (increases or decreases) one or more of the balance sheet elements—assets, liabilities, or stockholders' equity. A transaction may or may not affect (increase or decrease) an element of the statement of cash flows or the income statement. Some transactions affect elements of both statements, some transactions affect only one statement and not the other, and some transactions affect neither statement.
    b. What effect does a cash transaction have on a company's financial statements?
        i. Answer: Every cash transaction increases or decreases the asset (cash) on the balance sheet. Every cash transaction also increases or decreases an operating, investing, or financing activity on the statement of cash flows.

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Additional Activities and Assignments

The following are activities and assignments developed by Cengage but not included in the text, PPTs, or courseware (if courseware exists)—they are for you to use if you wish.

1. **Writing Activity**: *Using Common-Sized Income Statements for Comparison* (Critical Thinking, Measurement, 2-6, PPT Slide 43); Duration: 15 minutes.
    a. How and why are common-sized income statements used by investors?
        i. Common-sized financial statements are useful in comparing companies with one another. Because common-sized statements are prepared with amounts expressed as percentages, it is easier to compare a company with its competitors. Through an analysis of a company's financial results over time, common-sized financial statements can help investors more easily identify

trends, inconsistencies, or significant changes in a company's financials.

b. Would an investor be interested in reviewing common-sized income statements based on operating income or net income?
    i. When comparing operating performance across companies within the same industry, common-sized income statements are often prepared only through operating income rather than through net income. This is because other income and expenses are influenced by a variety of factors that are independent of operations and that can vary significantly across companies. For example, differences in the financing and tax strategies used by companies affect the comparability.

2. **Writing Activity**: *Historical Summaries* (Critical Thinking, Measurement, 2-6, PPT Slides 44–45); Duration: 10 minutes.
    a. Many annual reports include a historical summary section. Why would information that is five to ten years old be presented in an annual report?
        i. Although not specifically discussed in the text, a historical summary may provide significant insight to investors about past events that have had an impact on current financial statements. Historical data can also provide evidence of past trends that may reinforce positive results over extended periods.

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Additional Resources

Cengage Video Resources

- 6 Tell Me More videos (1 for each learning objective)
- 8 Show Me How videos

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