Chapter 2
Qualities of Accounting Information

LEARNING OBJECTIVES

1. Define generally accepted accounting principles and explain why they are necessary.
2. Explain the objective of financial reporting and the qualities of financial information necessary to achieve this objective.
3. Identify the elements of the financial statements and describe their characteristics.
4. Explain how accrual basis accounting differs from cash basis accounting, and identify examples of accrual basis accounting on actual financial statements.
5. Compute and explain the meaning of the current ratio.
6. Identify the risks and potential frauds related to financial accounting records, and explain the controls needed to ensure their accuracy.

Questions

1. What is GAAP? What is IFRS?

Solution:
GAAP is the set of guidelines called generally accepted accounting principles that a publicly traded company in the United States must follow when preparing its financial statements to help ensure consistency. IFRS stands for international financial reporting standards and is the set of principles set by the International Accounting Standards Board and is in use in many places throughout the world.

2. Name the four characteristics that help make accounting information useful.

Solution:
Information should be relevant, reliable, consistent, and comparable.

3. What is the separate-entity assumption?

Solution:
The separate entity assumption means that the financial records of the owner(s) are kept separate from the firm's records and the firm is a "separate entity."

4. Why would the going-concern assumption be important to a bank giving a business a loan?

Solution:
A bank would only want to loan money to a firm that was going to continue operations in the forseeable future; otherwise, it would be unlikely the bank would be able to collect repayment of the loan.

5. Explain materiality and give an example of both a material and an immaterial item.

Solution:
Materiality refers to the financial significance of the amounts reported in the financial statements or to the significance of an item or transaction. For example, a $5 wastebasket with a life longer than one year is *immaterial* in amount would be reported as an expense on the income statement rather than as an asset on the balance sheet. A piece of furniture that costs $10,000 and will last 5 years, on the other hand, is material and will be placed as an asset on the balance sheet.

6. What are the four basic financial statements?

Solution:
The four basic financial statements are the income statement, balance sheet, statement of changes in shareholders' equity, and statement of cash flows.

7. Which financial statement pertains to a single moment in time?

Solution:
The balance sheet pertains to a single moment in time.

8. What is a current asset? What is a current liability?

Solution:
A current asset is something of future value to the firm that will be used or converted to cash in the coming year. A current liability is an obligation that will be satisfied (with current assets) or paid in the coming year.

9. What are the two ways that shareholders' equity is generated in a business?

Solution:
Equity is generated by (1) contributions from owners, and (2) by net income from the operations of the firm—earned equity.

10. What does the income statement report about a firm? Name the types of accounts that appear on the income statement.

Solution:
The income statement reports the firm's performance during an accounting period. It includes revenue and expense accounts.

11. What is the purpose of the statement of cash flows? How are the cash flows categorized? What is the significance of classifying cash flows into these categories?

Solution:
The statement of cash flows shows all of the cash inflows and all of the cash outflows that occurred during the accounting period. Cash flows are classified as cash from operating activities, cash from investing activities, and cash from financing activities. These classifications help investors see exactly how a firm is getting its cash and spending its cash.

12. What is the full-disclosure principle?

Solution:
The full-disclosure principle means that the firm must disclose any circumstances and events that would make a difference to the users of the financial statements.

13. What does *recognize revenue* mean in accounting?

Solution:
To recognize revenue means to record it so that it will show up on the income statement.

14. What is the matching principle?

Solution:
According to the matching principle, costs are matched to revenues. In other words, costs are included as expenses on the same income statement as the revenues they help generate. For example, sales commissions would be an expense on the same income statement as the sales to which they pertain are shown as revenue. Matching relates to revenues and expenses.

15. What is an accrual? What is a deferral?

Solution:
An accrual transaction is one in which the revenue is earned or the expense is incurred before the exchange of cash. A deferral transaction is one in which the exchange of cash takes place before the revenue is earned or the expense incurred.

16. Must a company collect the money from a sale before the sale can be recognized?

Solution:
No, according to accrual accounting, a company has to recognize a sale when the revenue is earned and collection is reasonably assured no matter when the cash is collected.

17. What is the cost of goods sold?

Solution:

Cost of goods sold refers to the cost of the items (inventory) the company has sold. It's an expense.

18. Explain the difference between cash basis accounting and accrual basis accounting.

Solution:

Cash basis and accrual accounting differ in the timing in which revenue and expenses are recognized. In cash basis accounting, revenues and expenses are recognized (put on the income statement) when the actual exchange of cash occurs. By contrast, in accrual accounting, revenues are recognized when they are earned and expenses are recognized when they are incurred. When preparing generally accepted financial statements, accrual accounting is used.

19. How is the current ratio computed? What does it tell us about a company?

Solution:

The current ratio is computed by dividing the total amount of current assets by the total amount of current liabilities. The ratio gives information about a company's ability to fund its current operations in the short run.

20. Define internal control and explain why it is important.

Solution:

Internal controls are a company's policies and procedures to protect the assets of the firm and to ensure the accuracy and reliability of the accounting records. They are important because, by setting up and adhering to internal controls, a company minimizes the risks of being in business.

21. For each of the controls given, tell whether it is primarily a preventive control, a detective control, or a corrective control.

a. Retro Clothing, Inc., has an online purchase system that automatically inserts the total price of each item a customer orders.
b. The teller double-checks the account number on the loan payment before applying payment.
c. External auditors are hired to audit the year-end financial statements.

Solution:

a. This is a preventive control. It prevents any error that a person might make in typing in the price.
b. This is a detective control. The teller is trying to detect whether or not an error has been made.
c. External auditors are primarily a detective control, because they detect errors. However, just their existence as part of the firm's internal control system might serve as a preventive control. Plus, the auditors will make corrections before the financial statements are issued, so they might also serve as a corrective control.

Multiple-Choice Questions

1. If revenue exceeds expenses for a given period,
a. total assets for the period will decrease.
b. cash for the period will increase.
c. the income statement will report net income.
d. liabilities for the period will decrease.

2. The matching principle is best described as the process of
a. matching assets to liabilities and owners' equity.
b. recognizing a cost as an expense in the period in which it is used to generate revenue.
c. matching cash collections to revenue.
d. matching income to owners' equity.

3. Which of the following would never appear on a company's income statement?
a. Prepaid insurance
b. Cost of goods sold
c. Interest expense
d. Sales revenue

4. Which of the following statements is consistent with accrual basis accounting?
a. Revenues are recorded when cash is received.
b. Expenses are recorded when cash is paid.
c. Expenses are recorded in a different period than the related revenue.
d. Revenues are recorded when earned and expenses are matched with the revenues.

5. Sales revenue is most often recognized in the period in which
   a. the customer agrees to purchase the merchandise.
   b. the seller agrees to sell the merchandise to the customer at a specified price.
   c. the seller collects cash from the customer.
   d. the seller delivers the merchandise to the customer.
6. Which of the following is an example of a financing cash outflow?
   a. Borrowing money from a bank by signing a long-term note payable
   b. Financing the purchase of a new factory by issuing new shares of stock
   c. Paying a cash dividend to stockholders
   d. Purchasing a new delivery truck
7. How are assets reported in the balance sheet?
   a. Chronologically
   b. Alphabetically
   c. In the order of their liquidity
   d. In the order of their relative values
8. Which of the following financial statement elements is found on the balance sheet?
   a. Insurance expense
   b. Retained earnings
   c. Sales revenue
   d. All of the above
9. A company's current ratio is 1.85. You can safely conclude that
   a. the company is a good investment.
   b. the company will have no trouble paying its current obligations.
   c. the company has a short-term problem related to paying its bills.
   d. the company has a long-term problem related to meeting its obligations.
10. Which of the following is not a type of internal control?
   a. Preventive
   b. Corrective
   c. Collusion
   d. Detective

Short Exercises
Set A

SE2-1A. *Elements of the financial statements. (LO 3).* For each item that follows, tell whether it is an asset, a liability, or a shareholders' equity item.

1. Automobile
2. Prepaid insurance
3. Common stock
4. Unearned revenue
5. Accounts payable
6. Retained earnings
7. Accounts receivable
8. Inventory
9. Cash

Solution:

1	Asset
2	Asset
3	SH equity
4	Liability
5	Liability
6	SH equity
7	Asset
8	Asset
9	Asset

SE2-2A. *Elements of the financial statements. (LO 3).* For each of the following line items, give the financial statement on which it would appear.

Operating expense	Accounts payable
Sales revenue	Accounts receivable
Cost of goods sold	Net cash from operations
Equipment	Prepaid rent
Long-term debt	Advertising expense

Solution:

Operating expense	Income Statement
Accounts payable	Balance Sheet
Sales revenue	Income Statement
Accounts receivable	Balance Sheet
Cost of goods sold	Income Statement
Net cash from operations	Statement of Cash Flows
Equipment	Balance Sheet
Prepaid rent	Balance Sheet
Long-term debt	Balance Sheet
Advertising expense	Income Statement

SE2-3A. *Revenue recognition. (LO 3, 4).* Public Relations, Inc., managed a grand opening party on behalf of a new restaurant on April 15, 2009. Public Relations charged the restaurant $2,100. The restaurant paid for $1,800 of the bill from Public Relations, Inc., on April 20, 2009. The remaining balance was paid on May 5, 2009. How did these transactions affect Public Relations' income statement for the month of April and the balance sheet at April 30, 2009?

Solution:

Recorded revenue and accounts receivable: $2,100	Increased income; Increased assets (AR) on the balance sheet. (Income will increase SH's Equity.)
Received payment of part of the amount:	No effect on income; Assets on balance sheet are both increased (cash) and decreased (AR) by the same amount.

SE2-4A. *Accrual accounting versus cash basis accounting. (LO 4).* Missy & Adele Ice Cream, Inc., purchased inventory for its ice cream shop in August 2009\ for $55,000 cash to sell in August and September. The company sold inventory that cost $35,000 in August and the remainder in September. What is the cost of goods sold for August 2009 and the cost of goods sold for September 2009 if Missy & Adele uses GAAP? What is the cost of goods sold for each month if Missy & Adele uses cash basis accounting?

Solution:

August-Purchased inventory for $55,000	Using a cash-basis system, this would be an August expense. Using an accrual-basis system, this would have no effect on net income.
August-Sales of inventory that cost $35,000.	This would be cost of goods sold of $35,000 using GAAP.
September-Sales of inventory that cost $20,000.	This would be cost of goods sold of $20,000 uning GAAP.

SE2-5A. *Recording credit sales. (LO 4).* Wasil Company provided services on account for a customer that amounted to $1,000. How would this transaction be shown in the accounting equation?

Solution:

Assets:	=	Liabilities	+	SH Equity
				Retained Earnings
+ 1,000 Accounts receivable				+1,000 Service revenue

SE2-6A. *Accounts payable versus accounts receivable. (LO 4).* Bolo Company purchased inventory on account in the amount of $500. Then, Bolo sold the inventory to a customer for $1,000. Bolo extended credit to this customer. In other words, the sale was made on account. Related to these two transactions, how much did Bolo record as accounts payable? How much did Bolo record as accounts receivable?

Solution:

Bolo recorded $500 as Accounts payable for the purchase of inventory.
Bolo recorded $1,000 as Accounts receivable for the sale of the inventory.

SE2-7A. *Cash versus credit sales. (LO 3, 4).* Company A had sales of $1,500 during the year and collected them all in cash. Company B, on the other hand, had sales of $1,500 during the year but collected only $1,000 cash with the remaining $500 sales on account. Both firms had expenses of $700, all paid in cash by both firms. What was Company A's net income for the year? What was Company B's net income for the year? What was Company A's net cash from operating activities during the year? What was Company B's net cash from operating activities during the year?

Solution:

For both Company A and Company B

Revenue	$1,500
Expenses	700
Net income	$ 800

Net cash from operating activities:

Company A: $1,500 - 700 = $800

Company B: $1,000 - 700 = $300

SE2-8A. *Costs versus expenses. (LO 3).* The cost of supplies purchased by the Decker Company was $5,000 during the year. Decker used $4,000 worth of those supplies during the year and still had $1,000 worth of them left at year end. What was the amount of Decker's supplies expense for the year?

Solution:

Cost of the supplies:	$5,000
Supplies expense:	$4,000 (just the amount used)

SE2-9A. *Interest payment and cash flows. (LO 4).* Suppose Miller Hardware borrowed $10,000 from the local bank, with payments of principal and interest due each month. For April, Miller paid the bank $1,000 of principal and $50 interest. How would these cash flows be classified on the statement of cash flows?

Solution:

Principal payment of $1,000 is classified as a financing activity.	Interest payment of $50 is classified as an operating cash flow.

SE2-10A. *Compute and explain current ratio. (LO 5).* Given the following information, compute the current ratio for the two years shown. Explain the trend in the ratio for both years and what you think it means.

From balance sheet at	06/30/2010	06/30/2011
Current assets	$300,000	$360,000
Current liabilities	$200,000	$300,000

Solution:

Current ratio provides a measure of a company's ability to meet its short term obligations. The decrease in the ratio from 1.5 at the end of fiscal 2010 to 1.2 at the end of fiscal 2011 reflects a decrease in liquidity, which may mean that the company could have a more difficult time paying its current debts.

From balance sheet at	6/30/10	6/30/11
Current assets	$300,000	$360,000
Current liabilities	$200,000	$300,000

$$\text{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$2010 \quad 1.50 = \frac{\$300,000}{\$200,000}$$

$$2011 \quad 1.20 = \frac{\$360,000}{\$300,000}$$

Set B

SE2-11B. *Elements of the financial statements. (LO 3).* For each item that follows, tell whether it is an asset, a liability, or a shareholders' equity item.

1. Prepaid insurance
2. Accounts receivable
3. Retained earnings
4. Cash
5. Notes payable
6. Supplies

Solution:

1	Asset
2	Asset
3	SH equity
4	Asset
5	Liability
6	Asset

SE2-12B. *Elements of the financial statements. (LO 3).* For each of the following line items, give the financial statement on which it would appear.

Salary expense	Service revenue
Sales revenue	Accounts payable
Cost of goods sold	Net cash from financing activities
Land	Prepaid insurance
Notes payable	Marketing expenses

Solution:

Salary expense	Income Statement
Service revenue	Income Statement
Sales revenue	Income Statement
Accounts payable	Balance Sheet
Cost of goods sold	Income Statement
Net cash from financing activities	Statement of Cash Flows
Land	Balance Sheet
Prepaid insurance	Balance Sheet
Notes payable	Balance Sheet
Marketing expenses	Income Statement

SE2-13B. *Revenue recognition. (LO 3, 4).* Myadd, Inc., spent $3,000 on catering for its grand opening. Myadd paid the caterer half of the bill at the event, and requested a bill for the remaining half. The following day, Myadd's accountant had to record the transaction. Show what he or she recorded by using the accounting equation.

Solution:

Assets:	=	Liabilities	+	SH Equity
				Retained Earnings
- 1,500 Cash		+1,500 Accts. Payable		-3,000 Grand Opening Expense

SE2-14B. *Accrual accounting versus cash basis accounting. (LO 4).* At the beginning of January, Conway Coffee Bean Shop purchased inventory for $5,000 cash to sell in January and February. The shop sold inventory that cost $2,100 in January and the remainder in February. What is the cost of goods sold for January and the cost of goods sold for February if Conway Coffee uses GAAP? What is the cost of goods sold for each month if Conway Coffee uses cash basis accounting?

Solution:

January-Purchased inventory for $5,000.	Using a cash-basis system, this would be a January expense. Using an accrual-basis system, this would have no effect on net income.
January-Sales of inventory that cost $2,100.	This would be cost of goods sold for January of $2,100 using GAAP.
February-Sales of inventory that cost $2,900.	This would be cost of goods sold for February of $2,900.

SE2-15B. *Recording credit sales. (LO 4).* Jaybee Company provided services on account for a customer that amounted to $400. How would this transaction be shown in the accounting equation?

Solution:

Assets:	=	Liabilities	+	SH Equity
				Retained Earnings
+ 400 Accounts receivable				+400 Service revenue

SE2-16B. *Accounts payable versus accounts receivable. (LO 4).* Renata Jewels purchased inventory on account in the amount of $10,000. Then, the store sold the inventory to customers for $17,500. Renata extended credit to its customers. In other words, all sales were made on account. Related to these two transactions, how much did Renata Jewels record as accounts payable? How much did Renata Jewels record as accounts receivable?

Solution:

Renata recorded $10,000 as Accounts payable for the purchase of inventory.
Renata recorded $17,500 as Accounts receivable for the sale of the inventory.

SE2-17B. *Cash versus credit sales. (LO 3, 4).* Company X had sales of $7,500 during the year and collected half of them in cash. Company Y, on the other hand, had sales of $7,500 during the year and collected all in cash. Both firms had expenses of $2,400, paid in cash by both firms. What was Company X's net income for the year? What was Company Y's net income for the year? What was Company X's net cash from operating activities during the year? What was Company Y's net cash from operating activities during the year?

Solution:

For both Company X and Company Y

Revenue	$7,500
Expenses	2,400
Net income	$ 5,100

Net cash from operating activities:

Company X: $3,750 - 2,400 = $1,350

Company Y: $7,400 - 2,400 = $5,000

SE2-18B. *Costs versus expenses. (LO 3).* The cost of supplies purchased by the Alpha Company was $1,000 during the year. Alpha used $460 worth of those supplies during the year and still had $540 worth of them left at year end. What was the amount of Alpha's supplies *expense* for the year?

Solution:

Cost of the supplies:	$ 1,000	
Supplies expense:	$ 460	just the amount used

SE2-19B. *Interest payment and cash flows. (LO 4).* Suppose Betty's Beauty Supplies borrowed $40,000 from the local bank, with payments of principal and interest due each month. For the month of August, Betty's paid the bank $4,000 of principal and $200 interest. How would these cash flows be classified on the statement of cash flows?

Solution:

Principal payment of $4,000 is classified as a financing activity.	Interest payment of $200 is classified as an operating cash flow.

SE2-20B. *Compute and explain current ratio. (LO 5).* Given the following information, compute the current ratio for the two years shown. Explain the trend in the ratio for both years and what you think it means.

From balance sheet at	**09/30/2010**	**09/30/2011**
Current assets	$13,000	$11,000
Current liabilities	$10,000	$10,000

Solution:

Current ratio provides a measure of a company's ability to meet its short term obligations. The decrease in the ratio from 1.3 at the end of fiscal 2010 to 1.1 at the end of fiscal 2011 reflects a decrease in liquidity, which may mean that the company could have a more difficult time paying its current debts.

From balance sheet at	9/30/2010	9/30/2011
Current assets	$13,000	$11,000
Current liabilities	$10,000	$10,000

$$\text{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$2010 \quad 1.30 = \frac{\$13{,}000}{\$10{,}000}$$

$$2011 \quad 1.10 = \frac{\$11{,}000}{\$10{,}000}$$

Exercises
Set A

E2-21A. *Elements of the financial statements. (LO 3).* The following accounts and balances were taken from the financial statements of Electronic Super Deals, Inc. For each item, identify the financial statement(s) on which the item would appear. Then, identify each balance sheet item as an asset, a liability, or a shareholders' equity account.

Equipment	$120,000
Accounts receivable	105,000
Inventory	225,000
Long-term notes payable	315,025
Net cash from operating activities	28,000
Common Stock	35,150
Land	575,000
Retained earnings	100,000
Cash	340,000
Interest payable	650
Long-term mortgage payable	85,000
Salaries payable	21,525
Net cash from financing activities	18,000

Solution:

Equipment	$ 120,000	Balance sheet - asset
Accounts Receivable	105,000	Balance sheet - asset
Inventory	225,000	Balance sheet - asset,
Bonds payable	315,025	Balance sheet - liability
Net cash from operating activities	28,000	Statement of cash flows
Common stock	35,150	Statement of changes in shareholders' equity, Balance sheet - shareholders' equity item
Land	575,000	Balance sheet - asset
Retained earnings	100,000	Statement of changes in shareholders' equity, Balance sheet - shareholders' equity item
Cash	340,000	Balance sheet - asset Statement of cash flows
Interest payable	650	Balance sheet - liability
Long-term mortgage payable	85,000	Balance sheet - liability
Salaries payable	21,525	Balance sheet - liability
Net cash from financing activities	18,000	Statement of cash flows

E2-22A. *Net income and retained earnings. (LO 3).* Jule's Dairy Farm, Inc., reported the following (incomplete) information in its records for 2010:

Net income	$ 25,000
Sales	115,000
Beginning balance—retained earnings	20,000
Cost of goods sold	45,000
Dividends declared and paid	2,250

1. If the sales revenue given is the only revenue for the year, what were the expenses for the year other than cost of goods sold?
2. What is the balance of retained earnings at the end of 2010?

Solution:

1 $115,000 – $45,000 – x = $25,000

x = 45,000

2 $20,000 +$25,000 – $2,250 = **$42,750**

E2-23A. *Elements of the financial statements. (LO 3).* Listed are elements of the financial statements discussed in this chapter. Match each element with the descriptions (use each as many times as necessary).

a. Assets
b. Liabilities
c. Shareholders' equity
d. Revenues
e. Expenses

1. _____ Debts of the company
2. _____ Economic resources with future benefit
3. _____ Inflows of assets from delivering or producing goods or services
4. _____ Things of value a company owns
5. _____ The residual interest in the assets of an entity that remains after deducting its liabilities
6. _____ The difference between what the company has and what the company owes
7. _____ The owners' interest in the company
8. _____ Outflows or using up of assets from delivering or producing goods and services
9. _____ Costs that have no future value
10. _____ The amount the company owes
11. _____ Sales

Solution:

1. b—liabilities
2. a—assets
3. d—revenues
4. a—assets
5. c—equity
6. c—equity
7. c—equity
8. e—expenses
9. e—expenses
10. b—liabilities
11. d—revenues

E2-24A. *Balance sheet and income statement transactions. (LO 3, 4).* Unisource Company started the first year of operations with $2,000 in cash and common stock. During 2010, the Unisource Company earned $4,600 of revenue on account. The company collected $4,200 cash from accounts receivable and paid $2,850 cash for operating expenses. Enter the transactions into the accounting equation.

1. What happened to total assets (increase or decrease and by how much)?
2. What is the cash balance on December 31, 2010?
3. What is the total shareholders' equity on December 31, 2010?
4. What is net income for the year?

Solution:

	Total Assets	=	Total Liabilities	+	Shareholders' equity: Contributed Capital	+	Shareholders' equity: Retained Earnings
	Beginning Balances:						
a	+ 2,000 Cash				+ 2,000 Common stock		
b	+ 4,600 Account receivable						+ 4,600 Revenue
c	+ 4,200 cash (4,200) accounts receivable						
d	(2,850) cash						(2,850) Operating expenses
	$3,750	=	$0	+	**$2,000**	+	**$1,750**

1. Assets increased by $1,750
2. Cash balance at December 31, 2010 is $3,350
3. The total shareholders' equity on December 31, 2010 is $3,750
4. Net Income for the year is $1,750

E2-25A. *Income statement preparation. (LO 3).* Use the following to prepare an income statement for Excel Technology, Inc., for the year ended June 30, 2011:

Service revenues	$62,675
Rent expense	12,000
Insurance expense	6,550
Salary expenses	18,625
Administrative expenses	5,720

Solution:

Excel Technology, Inc.
Income Statement
For the year ended June 30, 2011

Service revenues		$ 62,675
Expenses:		
Rent expense	$ 12,000	
Insurance expense	6,550	
Salary expenses	18,625	
Administrative expenses	5,720	
Total expenses:		42,895
Net income		$ 19,780

E2-26A. *Classified balance sheet preparation. (LO 3).* The following items were taken from the December 31, 2012, financial statements of Whitehouse Corporation. (All dollars are in millions.) Prepare a classified balance sheet as of December 31, 2012.

Property and equipment	$15,225	Salaries payable	11,250
Common stock	15,895	Other noncurrent liabilities	1,445
Investment in land	13,215	Retained earnings	8,835
Short-term investments	1,900	Prepaid insurance	675
Cash	1,850	Other noncurrent assets	6,795
Accounts receivable	185	Interest payable	845
Supplies	110	Mortgage payable	1,685

Solution:

Whitehouse Corporation
Balance Sheet
At December 31, 2012
(in millions)

Assets			
Current assets			
Cash	$ 1,850		
Short-term investments	1,900		
Accounts receivable	185		
Supplies	110		
Prepaid Insurance	675		
Total current assets		$ 4,720	
Non-current assets			
Investment in land	13,215		
Property & equipment	15,225		
Other non-current assets	6,795		
Total non-current assets		35,235	
Total assets			$ 39,955
Liabilities and Shareholders' Equity			
Current liabilities			
Salaries payable	$ 11,250		
Interest payable	845		
Total current liabilities		$ 12,095	
Non-current liabilities			
Mortgage payable	1,685		
Other non-current liabilities	1,445		
Total non-current liabilities		3,130	
Total liabilities			$ 15,225
Shareholders' equity			
Common stock		15,895	
Retained earnings		8,835	
Total shareholders' equity			24,730
Total liabilities and shareholders' equity			$ 39,955

E2-27A. *Current ratio. (LO 5).* Use the balance sheet you prepared in E2-26A to compute the current ratio at December 31, 2012.

Solution:

$$\text{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$= \frac{4{,}720}{12{,}095} = \boxed{0.39}$$

Current ratio provides a measure of a company's ability to meet its short term obligations. Whitehouse Corporation has only $0.39 of current assets with which to pay off each $1.00 of its current liabilities.

Unless Whitehouse brings in a lot of cash on a regular basis, this low current ratio may indicate trouble.

E2-28A. *Current ratio. (LO 5).* The following data was taken from the 2009 and 2008 financial statements of Tasty Sweets Corporation. Calculate the current ratio for each year. What happened to the company's liquidity from 2008 to 2009?

	2009	2008
Current assets	384,728	385,642
Total assets	649,803	590,112
Current liabilities	151,084	157,990
Total liabilities	261,676	282,244
Total shareholders' equity	388,127	307,868

Solution:

Tasty Sweets Corporation.

	2009	2008
Current assets	$ 384,728	$ 385,642
Total assets	649,803	590,112
Current liabilities	151,084	157,990
Total liabilities	261,676	282,244
Total shareholder's equity	388,127	307,868

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$2009 \quad 2.55 = \frac{\$\ 384{,}728}{151{,}084}$$

$$2008 \quad 2.44 \quad \frac{\$\ 385{,}642}{157{,}990}$$

The current ratio increased from 2008 to 2009, resulting in increased liquidity.

Set B

E2-29B. *Elements of the financial statements. (LO 3).* The following accounts and balances were taken from the financial statements of Books & Media, Inc. For each item, identify the financial statement(s) on which the item would appear. Then, identify each balance sheet item as an asset, a liability, or a shareholders' equity account.

Inventory	$ 81,250
Accounts payable	52,300
Cash	77,880
Short-term notes payable	32,200
Net cash from investing activities	49,300
Building	76,475
Common stock	105,000
Retained earnings	63,000
Net cash from financing activities	21,080
Accounts receivable	44,270
Long-term mortgage payable	54,000
Taxes payable	1,500
Net cash from operating activities	34,350

Solution:

Inventory	$ 81,250	Balance sheet - asset
Accounts payable	52,300	Balance sheet - liability
Cash	77,880	Balance sheet - asset, Stmt.of cash flows
Short-term notes payable	32,200	Balance sheet - liability
Net cash from investing activities	49,300	Statement of cash flows
Building	76,475	Balance sheet - asset
Common stock	105,000	Stmt. of changes in shareholders' equity, Balance sheet -shareholders' equity item
Retained earnings	63,000	Stmt. of changes in shareholders' equity, Balance sheet - shareholders' equity item
Net cash from financing activities	21,080	Statement of cash flows
Accounts receivable	44,270	Balance sheet - asset
Long-term mortgage payable	54,000	Balance sheet - liability
Taxes payable	1,500	Balance sheet - liability
Net cash from operating activities	34,350	Statement of cash flows

E2-30B. *Net income and retained earnings. (LO 3).* Donut Hole, Inc., reported the following (incomplete) information in its records for 2011:

Net income	$ 52,000
Sales	153,750
Beginning balance—retained earnings	15,445
Cost of goods sold	68,000
Dividends declared and paid	3,025

1. If the sales revenue given is the only revenue for the year, what were the expenses for the year other than cost of goods sold?
2. What is the balance of retained earnings at the end of 2011?

Solution:

1 $153,750 – $68,000 – x = $52,000
x = 33,750

2 $15,445 +$52,000 – $3,025 = **$64,420**

E2-31B. *Elements of the financial statements. (LO 3).* Listed are elements of the financial statements discussed in this chapter. Match each element with the descriptions (use each as many times as necessary).

a. Assets
b. Liabilities
c. Shareholders' equity
d. Revenues
e. Expenses
f. Retained earnings
g. Common stock

1. _____ Note signed with a bank
2. _____ Rent paid a year in advance
3. _____ Items that make up net income that appear on the income statement
4. _____ Items that appear on the balance sheet
5. _____ A share of ownership in a corporation
6. _____ Equity that results from doing business and is kept in the company rather than paid out to stockholders
7. _____ Shareholders' interest in the company
8. _____ Costs of the daily operations of a business
9. _____ Salaries owed to employees
10. _____ Cost of inventory when it is sold
11. _____ Revenue received for services not yet provided
12. _____ Interest received on notes receivable

Solution:

1. b—liabilities
2. a—assets
3. d—revenues, e—expenses
4. a—assets, b—liabilities, c—equity, f—retained earnings, g—common stock
5. g—common stock, c—equity
6. f—retained earnings, c—equity
7. c—equity
8. e—expenses
9. b—liabilities
10. e—expenses
11. b—liabilities
12. d—revenues

E2-32B. *Balance sheet and income statement transactions. (LO 3, 4).* Pet Caterers, Inc., started the first year of operations with $3,500 in cash and common stock. During 2012, Pet Caterers earned $6,500 of revenue on account. The company collected $5,900 cash from accounts receivable and paid $3,115 cash for operating expenses. Enter the transactions into the accounting equation.

1. What happened to total assets (increase or decrease and by how much)?
2. What is the cash balance on December 31, 2012?
3. What is the total shareholders' equity on December 31, 2012?
4. What is net income for the year?

Solution:

				Shareholders' equity		
Total Assets	=	Total Liabilities	+	Contributed Capital	+	Retained Earnings
Beginning Balances:						
+3,500 Cash				+ 3,500 Common stock		
a. + 6,500 Account receivable						+ 6,500 Revenue
b. + 5,900 cash (5,900) accounts receivable						
c. (3,115) cash						(3,115) Operating expenses
$6,885	=	$0	+	**$3,500**	+	**$3,385**

1. Assets increased by $3,385
2. Cash balance at December 31, 2012 is $6,285
3. The total shareholders' equity on December 31, 2012 is $6,885
4. Net Income for the year is $3,385

E2-33B. *Income statement preparation. (LO 3).* Use the following to prepare an income statement for Grace's Landscape Service, Inc., for the year ended June 30, 2011:

Service revenue	$37,515
Rent expense	8,675
Insurance expense	2,125
Other operating expenses	12,075
Salary expense	10,650

Solution:

Grace's Landscaping, Inc.
Income Statement
For the year ended June 30, 2011

Service revenues		$ 37,515
Expenses:		
Rent expense	$ 8,675	
Insurance expense	2,125	
Salary expense	10,650	
Other operating expenses	12,075	
Total Expenses:		33,525
Net Income		$ 3,990

E2-34B. *Classified balance sheet preparation. (LO 3).* The following items were taken from the December 31, 2012, financial statements of Organic Vegetables, Inc. (All dollars are in thousands.) Prepare a classified balance sheet as of December 31, 2012.

Land and building	$6,750	Accounts payable	4,125
Common stock	3,651	Other noncurrent liabilities	2,150
Long-term investments	2,175	Retained earnings	1,297
Short-term investments	615	Other current assets	1,100
Cash	1,260	Vehicles	3,267
Accounts receivable	575	Current portion of long-term debt	1,160
Inventories	505	Long-term debt	3,864

Solution:

Organic Vegetables, Inc.
Balance Sheet
At December 31, 2012
(in thousands)

ASSETS			
Current Assets:			
Cash	$ 1,260		
Accounts receivable	575		
Short-term investments	615		
Inventories	505		
Other current assets	1,100		
Total current assets		$ 4,055	
Long-term investments	2,175		
Vehicles	3,267		
Land and building	6,750		
Total non-current assets		12,192	
Total assets			$ 16,247
LIABILITIES & SHAREHOLDERS' EQUITY			
Current Liabilities:			
Accounts payable	$ 4,125		
Current portion of long-term debt	1,160		
Total current liabilities		5,285	
Long-term debt		3,864	
Other non-current liabilities		2,150	
Total liabilities			$ 11,299
Shareholders' Equity ;			
Common stock		3,651	
Retained earnings		1,297	
Total Shareholders' Equity			4,948
Total Liabilities and Shareholders' Equity			$ 16,247

E2-35B. *Current ratio. (LO 5).* Use the balance sheet you prepared in E2-34B to compute the current ratio at December 31, 2012.

Solution:

$$\text{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$= \frac{\$\ 4{,}055}{\$\ 5{,}285} = \boxed{0.77}$$

Current ratio provides a measure of a company's ability to meet its short term obligations. Organic Vegetables, Inc., has $0.77 of current assets with which to pay off each $1.00 of its current liabilities. In most industries having a ratio over 1 is desirable. If Organic Vegetables brings in a great deal of cash on a regular basis, the company should have no trouble paying its current debts.

E2-36B. *Current ratio. (LO 5).* The following data was taken from the 2011 and 2010 financial statements of Shelby Pet Supplies Company. Calculate the current ratio for each year. What happened to the company's liquidity from 2010 to 2011?

	2011	**2010**
Current assets	105,000	142,000
Total assets	275,000	376,750
Current liabilities	55,000	115,000
Total liabilities	125,000	175,000
Total shareholders' equity	150,000	201,750

Solution:

Shelby Pet Supplies Company

	2011	2010
Current assets	$105,000	$142,000
Total assets	275,000	376,750
Current liabilities	55,000	115,000
Total liabilities	125,000	175,000
Total shareholders' equity	150,000	201,750

$$\text{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$2011 \quad 1.91 = \frac{\$105{,}000}{\$55{,}000}$$

$$2010 \quad 1.23 \quad \frac{\$142{,}000}{\$115{,}000}$$

The current ratio increased from 2010 to 2011 resulting in increased liquidity.

Problems
Set A

P2-37A. *Relationships between financial statement items. (LO 3).* Use the information from Shane and Lane, Inc., for the year ended December 31, 2011, to answer the questions that follow. Assume that the shareholders made new contributions of $25 to the company during the year.

a. Expenses for the year ended December 31, 2011 = $625
b. Net income for the year ended December 31, 2011 = $415
c. Beginning balance (December 31, 2010, balance) in retained earnings = $215
d. Ending balance (December 31, 2011, balance) in retained earnings = $500
e. Total liabilities and shareholders' equity at December 31, 2011 = $875
f. Beginning balance (December 31, 2010, balance) in total liabilities = $260
g. Ending balance (December 31, 2011, balance) in total liabilities = $275

Requirements

1. What were the company's total revenues during the year ended December 31, 2011?
2. What was the amount of the dividends declared during the year ended December 31, 2011?
3. What is the total that owners had invested in Shane and Lane as of December 31, 2011?
4. What were total assets on the company's December 31, 2011, balance sheet?

Solution:

1.	Revenue	–	Expenses	=	Net Income
	Revenue	–	$625	=	$415
			Revenue	=	$1,040

2.	Beginning Retained Earnings	+	Net Income	–	Dividends	=	Ending Retained Earnings
	$215	+	$415	–	Dividends	=	$500
					Dividends	=	$130

3.	Liabilities	+	Contributed Capital	+	Retained Earnings	=	$875
	$275	+	Contributed Capital	+	$500	=	$875
			Contributed Capital			=	$100

4.	Assets	=	Liabilities	+	Contributed Capital	+	Retained Earnings
	Assets	=	$275	+	$100	+	$500
	Assets	=	$875				

P2-38A. *Analyzing transactions. (LO 3).* Accounting Services Corporation entered into the following transactions during 2010:

a. The company started as a corporation with a $14,700 cash contribution from the owners in exchange for common stock.
b. Service revenues on account amounted to $8,250.
c. Cash collections of accounts receivable amounted to $6,875.
d. Purchased supplies on account for $125 and used all of them.
e. On December 15, 2010, the company paid $6,000 in advance for leased office space. The lease does not go into effect until 2011.

Requirements

Put each of the transactions in an accounting equation worksheet. Then, answer the following questions:

1. What is the amount of cash flow from operating activities for 2010?
2. What amount of total liabilities would appear on the December 31, 2010, balance sheet?
3. What is the amount of contributed capital as of December 31, 2010?
4. What amount of net income would appear on the income statement for the year ended December 31, 2010?

Solution:

				Shareholders' equity		
	Total Assets	=	Total Liabilities	+ Contributed Capital	+	Retained Earnings
a.	+ 14,700 Cash			+ 14,700 Common stock		
b.	+ 8,250 Accounts receivable					+ 8,250 Service revenue
c.	+ 6,875 Cash, (6,875) Accounts receivable					
d.			+125 Accounts payable			-125 supplies expense
e.	(6,000) Cash, + 6,000 Prepaid rent					

1 + 6,875 – 6,000 = $875 cash from operating activities

2 Total liabilities = $125

3 Contibuted capital = $14,700

4 + 8,250 - 125 = $8,125 Net income

P2-39A. *Analyzing transactions and preparing financial statements. (LO 3).* The following transactions occurred during MP Public Relations Firm's first month of business:

a. Marlene and Pamela opened up MP Public Relations Firm by contributing $22,750 on July 1, 2009, in exchange for common stock.
b. The firm borrowed $15,000 from the bank on July 1. The note is a 1-year, 10% note, with both principal and interest to be repaid on June 30, 2010.
c. The firm prepaid a year of rent for $1,200 that started August 1, 2009.
d. The firm paid $1,050 cash for operating expenses for the first month.
e. The firm earned $10,500 in revenue the first month. Of that amount, $7,500 was collected in cash.
f. The firm hired an administrative assistant and paid $525 cash in salary expense for the first month.
g. The firm declared and paid distributions to owners in the amount of $2,250 for the first month.
h. At the end of the month, $125 of interest payable is due but not yet paid on the note from item (b).

Requirements

1. Show how each transaction affects the accounting equation.
2. Prepare the income statement, statement of changes in shareholders' equity, and statement of cash flows for the month of July. Also, prepare the balance sheet *at* July 31.

Solution:

1.

	Total Assets	=	Total Liabilities	+	Shareholders' equity: Contributed Capital	+	Shareholders' equity: Retained Earnings
a.	+ 22,750 Cash				+ 22,750 Common stock		
b.	+ 15,000 Cash		+ 15,000 Notes payable				
c.	(1,200) Cash +1,200 Prepaid rent						
d.	(1,050) Cash						(1,050) Operating expenses
e.	+ 7,500 Cash +3,000 Accounts receivable						+ 10,500 Revenue
f.	(525) Cash						(525) Salary expense
g.	(2,250) Cash						(2,250) dividends
h.			+ 125 Interest payable				(125) Interest expense
Totals:	**$44,425**	**=**	**$15,125**	**+**	**$22,750**	**+**	**$6,550**

2.

MP Public Relations Firm
Income Statement
For the Month Ended July 31, 2009

Revenue		$10,500
Expenses		
Operating expenses	1050	
Salary expense	525	
Interest expense	125	1,700
Net income		$8,800

MP Public Relations Firm
Statement of Changes in Shareholder's Equity
For the Month Ended July 31, 2009

Beginning common stock	$ 0
Stock issued during the year	22,750
Common stock, ending balance	22,750
Beginning retained earnings	0
Net income for the year	8,800
Dividends	(2,250)
Ending retained earnings	$6,550

P2-39A Solution continued:

MP Public Relations Firm Balance Sheet At July 31, 2009	
Assets	
Cash	$40,225
Accounts receivable	3,000
Prepaid rent	1,200
Total assets	$44,425
Liabilities and Shareholder's Equity	
Note payable	$15,000
Interest payable	125
Common stock	22,750
Retained earnings	6,550
Total liabilities and shareholder's equity	$44,425

MP Public Relations Firm Statement of Cash Flows For the Month Ended July 31, 2009		
Cash from operating activities		
Cash collected from customers	$7,500	
Cash paid for rent	(1200)	
Cash paid for salaries	(525)	
Cash paid for operating expenses	(1050)	$4,725
Cash from financing activities		
Cash from issue of common stock	22750	
Cash dividends paid	(2250)	
Proceeds from loan	15,000	35,500
Net increase in cash		$40,225

P2-40A. *Analyze transactions from the accounting equation and prepare the four financial statements. (LO 3).* The following accounting equation worksheet shows the transactions for Data Services for its first month of business, May 2010:

	Assets			= Liabilities		+ Shareholders' Equity		
						Contributed Capital	Retained Earnings	
Transaction	Cash	All other assets	(Account)	All liabilities	(Account)	Common stock		
a.	$ 5,000					$5,000		
b.	15,000			15,000	Notes payable (5-year)			
c.	(10,000)	10,000	Land					
d.		6,500	Accounts receivable				6,500	Revenue
e.	12,000						12,000	Revenue
f.	(8,000)	8,000	Land					
g.	3,500	(3,500)	Accounts receivable					
h.	(2,100)						(2,100)	Expense
i.	(750)						(750)	Dividends

Requirements

1. Analyze each transaction in the accounting equation worksheet and describe the underlying exchange that resulted in each entry.
2. Has the company been profitable this month? Explain.
3. Prepare an income statement for the month ended May 31, 2010.
4. Prepare a statement of shareholders' equity for the month ended May 31, 2010.
5. Prepare a statement of cash flows for the month ended May 31, 2010.
6. Prepare a balance sheet at May 31, 2010.

Solution:

Assets				=	Liabilities		+	Shareholders' Equity	
	Cash	All other assets	(Account)		All liabilities	(Account)		Contributed capital	Retained earnings
a	$5,000							$5,000	
								Common stock	
b	15,000				15,000	Notes payable (5-year)			
c	-10,000	10,000	Land						
d		6,500	Accounts receivable						6,500 Revenue
e	12,000								12,000 Revenue
f	-8,000	8,000	Land						
g	3,500	-3,500	Accounts receivable						
h	-2,100								-2,100 Expense
i	-750								-750 Dividends
	$14,650								

1. a. Stock issued for cash contributions of $5,000.
   b. Borrowed $15,000 with a long-term note.
   c. Purchased land for $10,000 cash.
   d. Earned revenue on account for $6,500.
   e. Earned cash revenue of $12,000
   f. Purchased land for $8,000 cash.
   g. Collected $3,500 cash on accounts receivable.
   h. Paid expenses of $2,100.
   i. Paid dividends of $750.

2. Yes, revenue of $18,500 exceeded expenses of $2,100.

3. Data Services
   Income Statement
   For the month ended May 31, 2010

Revenue	$18,500
Expenses	(2,100)
Net income	$16,400

P2-40A Solution continued:

4.

Data Services
Statement of Changes in Shareholders' Equity
For the month ended May 31, 2010

Beginning Common stock	$	-
New stock issued		5,000
Ending Common stock	$	5,000
Beginning Retained earnings	$	-
Net income		16,400
Dividends paid		(750)
Ending Retained earnings	$	15,650
Total Shareholders' equity	$	20,650

5.

Data Services
Statement of Cash Flows
For the month ended May 31, 2010

Cash from operating activities:	
Cash collected from customers	$15,500
Cash paid for expenses	(2,100)
Net cash from operating activities	13,400
Cash from investing activities:	
Cash used for purchase of land	(18,000)
Net cash from investing activities	(18,000)
Cash from financing activities:	
Cash from stock issue	5,000
Cash from note payable	15,000
Cash used for dividends	(750)
Net cash from financing activities	19,250
Net increase in cash	$14,650
Add beginning cash	-
Ending cash balance	$14,650

6.

Data Services
Balance Sheet
At May 31, 2010

Assets	
Cash	$14,650
Accounts receivable	3,000
Land	18,000
Total assets	$35,650
Liabilities and Shareholders' Equity	
Notes payable	$15,000
Common stock	5,000
Retained earnings	15,650
Total liabilities and shareholders' equity	$35,650

P2-41A. *Analyzing transactions and preparing financial statements. (LO 3, 5).* After Nate, Maggie, Nicol, and Lindsay finished medical school, they decided to open a new medical practice named New Beginnings. The graduates formed New Beginnings, Inc., as a corporation on January 1, 2011. Each graduate contributed $65,000 to the business in exchange for 2,500 shares of common stock. The company signed a note with Noble Bank for an additional $120,000. The company used available funds to purchase office space (building) for $216,000. The company also purchased medical equipment on account for $139,000, with payment due at the beginning of the following year.

- During the first year of business, New Beginnings earned $280,000 in service revenue, but collected only $215,000; the remaining $65,000 was due from customers early the next year.
- Salary expenses for the year were $115,000, of which $95,000 was paid in cash during the year; the remaining $20,000 was due to employees the first day of the next year.
- The company purchased an insurance policy for $40,000 cash of which $5,000 was for the current year and the remainder was for future years.
- The company paid operating expenses of $39,000 in cash during the year.
- The company sent a check during the last month of the year for $8,100 for interest expense due on the loan from Noble Bank.
- The company invested $22,000 of cash in short-term investments at the end of the year.
- New Beginnings declared and paid cash dividends of $10,500 during the year.

Requirements

1. Show how each transaction affects the accounting equation.
2. Prepare the income statement, the statement of changes in shareholders' equity, and the statement of cash flows for the year ended December 31, 2011. Prepare the balance sheet *at* December 31, 2011. Ignore depreciation expense on building and equipment.
3. Calculate the current ratio at December 31, 2011.

Solution:

				Shareholders' equity		
	Total Assets	=	Total Liabilities	+	Contributed Capital	+ Retained Earnings
1.	+ 380,000 Cash		+ 120,000 Long-term notes payable		+ 260,000 Common Stock	
2.	(216,000) Cash + 216,000 Building					
3.	+ 139,000 Medical equipment		+ 139,000 Accounts payable			
4.	+ 215,000 Cash + 65,000 Accounts receivable					+ 280,000 Service revenue
5.	(-95,000) Cash		+ 20,000 Salaries payable			(115,000) Salaries expense
6.	(40,000) Cash '+ 35,000 Prepaid insurance					(5,000) Insurance expense
7.	(39,000) Cash					(39,000) Operating expenses
8.	(8,100) Cash					(8,100) Interest expense
9.	(22,000) Cash + 22,000 Short-term investments					
10.	(10,500) Cash					(10,500) Dividends
TOTALS	**$641,400**		**$279,000**		**$260,000**	**$102,400**

P2-41A Solution continued:

New Beginnings, Inc.
Income Statement
For the Year Ended December 31, 2011

Service revenue		$280,000
Expenses		
Salary expense	$ 115,000	
Insurance expense	5,000	
Operating expenses	39,000	
Interest expense	8,100	
Total expenses		167,100
Net income		$112,900

New Beginnings, Inc.
Statement of Changes in Shareholders' Equity
For the Year Ended December 31, 2011

Common stock		
Beginning balance	$ -	
Stock issued during the year	260,000	
Ending common stock balance		$260,000
Retained earnings		
Beginning balance	-	
+ Net income	112,900	
- Dividends	(10,500)	
Ending retained earnings balance		102,400
Total shareholders' equity		$362,400

New Beginnings, Inc.
Balance Sheet
At December 31, 2011

Assets		
Cash	$	164,400
Short-term investments		22,000
Accounts receivable		65,000
Prepaid insurance		35,000
Total current assets		286,400
Building		216,000
Medical equipment		139,000
Total assets	$	641,400
Liabilities and Shareholders' Equity		
Liabilities		
Salaries payable	$	20,000
Accounts payable		139,000
Total current liabilities		159,000
Long-term notes payable		120,000
Total liabilities		279,000
Shareholders' equity		
Common stock		260,000
Retained earnings		102,400
Total liabilities and shareholders' equity	$	641,400

New Beginnings, Inc. Statement of Cash Flows For the Year Ended December 31, 2011		
Cash from operations:		
Cash collected from customers	$ 215,000	
Cash paid for salary expense	(95,000)	
Cash paid for insurance	(40,000)	
Cash paid for operating expenses	(39,000)	
Cash paid for interest expense	(8,100)	
Net cash provided by operations		$ 32,900
Cash flows from investing activities		
Purchase of building	(216,000)	
Purchase of short-term investments	(22,000)	
Net cash used by investing activities		(238,000)
Cash from financing activities:		
Issuance of note payable	120,000	
Issuance of common stock	260,000	
Payment of dividends	(10,500)	
Net cash from financing activities		369,500
Net increase in cash		164,400
Add beginning cash		-
Cash balance at June 30, 2011		$164,400

c. Current Ratio:

Current assets/Current liabilities 1.801 = $\frac{\$286,400}{\$159,000}$

The current ratio is a measure of liquidity and indicates a firm's ability to pay short-term debts.

This company appears to be in good shape. The current ratio is more than 1, indicating that the company has fewer current liabilities than current assets. It should be able to meet its current debts in the upcoming year.

Set B

P2-42B. *Relationships between financial statement items. (LO 3).* Use the following information for Exotic Cruise Corporation for the year ended June 30, 2011, to answer the questions. Assume that the shareholders contributed $100 to the company during the year.

a. Revenues for the year ended June 30, 2011 = $650
b. Net income for the year ended June 30, 2011 = $215
c. Beginning balance (June 30, 2010, balance) in retained earnings = $280
d. Ending balance (June 30, 2011, balance) in retained earnings = $375
e. Total liabilities and shareholders' equity at June 30, 2011 = $755
f. Total liabilities at June 30, 2010 = $105
g. Total liabilities at June 30, 2011 = $130

Requirements

1. What were Exotic Cruise's total expenses during the year ended June 30, 2011?
2. What was paid to shareholders during the year ended June 30, 2011?
3. What is the total that owners had invested in Exotic Cruise Corporation as of June 30, 2011?
4. What were total assets on Exotic Cruise's June 30, 2011, balance sheet?

Solution:

a.

Revenues	–	Expenses	=	Net Income
$650	–	Expenses	=	$215
		Expenses	=	$435

b.

Beginning Retained Earnings	+	Net Income	–	Dividends	=	Ending Retained Earnings
$280	+	$215	–	Dividends	=	$375
				Dividends	=	$120

c.

Liabilities	+	Retained Earnings	+	Contributed Capital		L + SH Equity
$130	+	$375	+	Contributed Capital	=	$755
				Contributed Capital	=	$250

d. Liabilities + SH Equity was given as $755 at June 30, 2011. Assets will be the same: $755.

	Ending 30-Jun-11	Beginning 30-Jun-10
RE	375	280
L +CC +RE	755	535
L	130	105
CC	250	150

P2-43B. *Analyzing transactions. (LO 3).* New Magazine Company entered into the following transactions during 2012:

a. New Magazine Company started as a corporation with a $9,650 cash contribution from the owners in exchange for common stock.
b. The company purchased supplies for $1,000 with cash and used all of them.
c. Advertising revenues, all on account, amounted to $17,625.
d. Cash collections of accounts amounted to $8,175.
e. On October 15, 2012, the company paid $4,050 in advance for an insurance policy that does not go into effect until 2013.
f. The company declared and paid dividends of $575.

Requirements

Put each of the transactions in an accounting equation worksheet. Then, answer the following questions:

1. What is the amount of net cash from financing activities for the year ended December 31, 2012?
2. What amount of total assets would appear on the December 31, 2012, balance sheet?
3. What amount of net income would appear on the income statement for the year ended December 31, 2012?
4. What is the amount of retained earnings as of December 31, 2012?

Solution:

	Total Assets	=	Total Liabilities	+	Shareholders' equity: Contributed Capital	+	Shareholders' equity: Retained Earnings
a.	+ 9,650 Cash				+ 9,650 Common stock		
b.	(1,000) Cash						(1,000) Supplies expense
c.	+ 17,625 Accounts receivable						+ 17,625 Advertising revenue
d.	+ 8,175 Cash (8,175) Accounts receivable						
e.	(4,050) Cash + 4,050 Prepaid insurance						
f.	(575) Cash						(575) Dividends

1 $9,650 - 575 = $9,075 cash from financing activities

2 + 9,650 -1,000 + 17,625 – 575 = 25,700 total assets

3 $17,625 - $1,000 = 16,625 net income

4 + 17,625 – 1,000 - 575 = $16,050 retained earnings

P2-44B. *Analyzing transactions and preparing financial statements. (LO 3).* The following transactions occurred during Bono Exterminators' first month of business:

a. Joe Bono started a business, Bono Exterminators, by contributing $6,200 cash on January 1, 2010, in exchange for common stock.
b. The company borrowed $18,000 from the bank in January. The note is a 1-year, 5% note, with both principal and interest to be repaid on December 30, 2010.
c. The company paid $2,500 in cash for an insurance policy that begins February 1.
d. The company earned $4,775 in revenues during January. Cash collections of revenue amounted to $4,270 during the month.
e. The company paid operating expenses of $815 cash for the month of January.
f. The company declared and made distributions to owners in the amount of $125 cash in January.
g. At the end of January, $75 of interest payable is due on the note from item (b).

Requirements

1. Show how each transaction affects the accounting equation.
2. Prepare the income statement, statement of changes in shareholder's equity, and the statement of cash flows for the month of January and the balance sheet at January 31.

Solution:

	Total Assets	=	Total Liabilities	+	Shareholders' equity: Contributed Capital	+	Shareholders' equity: Retained Earnings
a.	+ 6,200 Cash				+ 6,200 Owner contribution		
b.	+ 18,000 Cash		+ 18,000 Notes payable				
c.	(2,500) Cash +2,500 Prepaid insurance						
d.	+ 4,270 Cash + 505 Accounts receivable						+ 4,775 Revenue
e.	(815) Cash						(815) Operating expenses
f.	(125) Cash						(125) Dividends
g.			+ 75 Interest payable				(75) Interest expense
Totals:	**$28,035**	**=**	**$18,075**	**+**	**$6,200**	**+**	**$3,760**

2

Bono Exterminators		
Income Statement		
For the month ended January 31, 2010		
Revenue		$4,775
Expenses		
Operating expenses	815	
Interest expese	75	890
Net income		$3,885

P2-44B Solution continued:

Bono Exterminators Statement of Changes in Shareholders' Equity For the month ended January 31, 2010		
Beginning common stock	$	0
Stock issued during the month		6,200
Ending common stock	$	6,200
Beginning retained earnings	$	0
Net income for the month		3,885
Dividends		(125)
Ending retained earnings	$	3,760
Total shareholders' equity	$	9,960

Bono Exterminators Balance Sheet At January 31, 2010	
Assets	
Cash	$25,030
Accounts receivable	505
Prepaid insurance	2,500
Total assets	$28,035
Liabilities and Shreholder's Equity	
Note payable	$18,000
Interest payable	75
Total liabilities	18,075
Common stock	6,200
Retained earnings	3,760
Total liabilities and shareholder's equity	$28,035

Bono Exterminators Statement of Cash Flows For the month ended January 31, 2010		
Cash from operating activities		
Cash collected from customers	$4,270	
Cash paid for insurance	(2500)	
Cash paid for operating expenses	(815)	$955
Cash from financing activities		
Issue of common stock	$6,200	
Cash dividends	(125)	
Proceeds from loan	18,000	24,075
Net increase in cash		$25,030

P2-45B. *Analyze transactions from the accounting equation, prepare the four financial statements, and calculate the current ratio. (LO 4, 5, 7).* The following accounting equation worksheet shows the transactions for Internet Advertising, a corporation, for the first month of business October 2009.

	Assets			= Liabilities		+ Shareholders' Equity		
						Contributed Capital	Retained Earnings	
Transaction	Cash	All other assets	(Account)	All liabilities	(Account)	Common stock		(Account)
a.	$17,250					$17,250		
b.	16,900			16,900	Long-term notes payable			
c.	(4,500)						(4,500)	Salary expenses
d.	1,500	1,500	Accounts receivable				3,000	Service revenue
e.		8,000	Supplies	8,000	Accounts payable			
f.	8,150	1,850	Accounts receivable				10,000	Service revenue
g.	1,000	(1,000)	Accounts receivable					
h.	(5,000)			(5,000)	Accounts payable			
i.	(4,100)						(4,100)	Operating expenses
j.	(165)						(165)	Dividends

Requirements

1. Analyze each transaction in the accounting equation worksheet and describe the underlying exchange that resulted in each entry.
2. Has the company been profitable this month? Explain.
3. Prepare an income statement for the month ended October 31, 2009.
4. Prepare a statement of shareholders' equity for the month ended October 31, 2009.
5. Prepare a statement of cash flows for the month ended October 31, 2009.
6. Prepare a balance sheet at October 31, 2009.
7. Calculate the current ratio at October 31, 2009.

Solution:

Given:

	Assets			=	Liabilities		+	Shareholders' Equity			
	Cash	Accounts receivable	Supplies		Accounts Payable	Notes payable		Contributed Capital	+	Retained Earnings	
a.	17,250							17,250	Common Stock		
b.	16,900					16,900					
c.	(4,500)									(4,500)	Salary expense
d.	1,500	1,500								3,000	Revenue
e.			8,000		8,000						
f.	8,150	1,850								10,000	Revenue
g.	1,000	(1,000)									
h.	(5,000)				(5,000)						
i.	(4,100)									(4,100)	Operating expenses
j.	(165)									(165)	Dividends
	31,035	2,350	8,000		3,000	16,900		17,250		4,235	
			41,385		41,385						

a. The owners started a business, Internet Advertising, Inc., by contributing $17,250 in exchange for common stock.
b. The company borrowed $16,900 from the local bank by signing a note.
c. Salary expense amounted to $4,500 and was paid in cash.
d. Service revenues of $3,000 were earned. Cash collections $1,500; On Account $1,500.
e. The company purchased supplies worth $8,000 on account.
f. Service revenues of $10,000 were earned. Cash collections $8,150; On Account $1,850.
g. The company received a $1,000 cash payment on accounts receivable from transaction 4 (or 6).
h. The company paid $5,000 of accounts payable owed from transaction 5.
i. Operating expenses amounted to $4,100 and were paid in cash.
j. On October 31, the company paid dividends of $165.

2 Yes, the company was profitable.

Revenue	$ 13,000
Expenses	8,600
Net income	$ 4,400

3

Internet Advertising, Inc.
Income Statement
For the month ended October 31, 2009

Service revenue		$ 13,000
Expenses		
Salary expense	$ 4,500	
Operating expenses	4,100	
Total expenses		8,600
Net income		$ 4,400

P2-44B Solution continued:

4

Internet Advertising, Inc.
Statement of Changes in Shareholders' Equity
For the month ended October 31, 2009

Common stock		
Beginning balance	$ -	
Contributions during the month	17,250	
Ending common stock balance		$ 17,250
Retained earnings		
Beginning balance	-	
+ Net income	4,400	
- Dividends	(165)	
Ending retained earnings balance		4,235
Total shareholders' equity		$ 21,485

5

Internet Advertising, Inc.
Statement of Cash Flows
For the month ended October 31, 2009

Cash from operations:		
Cash collected from customers	$ 10,650	
Cash paid for salary expense	(4,500)	
Cash paid for operating expenses	(4,100)	
Cash paid for supplies	(5,000)	
Net Cash used by operations		$ (2,950)
Cash from investing:		
Cash from financing activities:		
Issuance of Note	16,900	
Issuance of Common stock	17,250	
Distribution of Dividends	(165)	
Net Cash from financing activities		33,985
Net increase in cash		$ 31,035
Add beginning cash		-
Cash balance at November 30		$ 31,035

P2-45B Solution continued:

6

Internet Advertising, Inc. Balance Sheet At October 31, 2009	
Assets	
Cash	$ 31,035
Accounts receivable	2,350
Total current assets	33,385
Equipment	8,000
Total assets	$ 41,385
Liabilities and Shareholders' Equity	
Liabilities	
Accounts payable	$3,000
Total current liabilities	3,000
Long-term notes payable	16,900
Total liabilities	19,900
Shareholders' equity	
Common stock	17,250
Retained earnings	4,235
Total liabilities and shareholders' equity	$ 41,385

7 Current Ratio:

Current assets/Current liabilities $11.13 = \frac{\$33,385}{\$3,000}$

The current ratio is a measure of liquidity and indicates a firm's ability to pay short-term debts.

The higher the ratio the more liquid the company is. The current ratio for this company is very high. A current ratio can be too high. Cash makes up a large portion of this company's total current assets. However, a new firm often needs a great deal of cash to get through the first operating cycle.

P2-46B. *Analyzing transactions and preparing financial statements. (LO 3, 5).* Joanna Wu won a Web-designing contest and decided to start her own Web-design company. She contributed $200,000 in exchange for 1,000 shares of common stock and borrowed another $55,000 by signing a 4-year note with Quality Bank. She formed Wu Web Designs, Inc., on July 1, 2009. The business used available funds to purchase some land with an office building for $125,000 and office equipment and furniture for $25,000. The business also bought a computer system on account for $45,500; payment was due at the beginning of the following year.

- During the first year of business, Wu Web Designs earned $215,000 in service revenue, but had collected only $172,000; the remaining $43,000 was due early the next year.
- Salary expenses for the year were $95,000 of which the company paid $80,000 in cash during the year; the remaining $15,000 was due the first day of the next year.
- The company purchased an insurance policy for $24,000, of which $6,000 was for the current year and the remainder was for future years.
- The company paid operating expenses of $20,250 in cash during the year.
- Interest expense for the year was $7,175 but has not yet been paid.
- The company invested $20,000 of cash in a short-term investment at the end of the year.
- Wu Web Designs declared and paid dividends of $3,200 during the year.

Requirements

1. Show how each transaction affects the accounting equation.
2. Prepare the income statement, statement of changes in shareholder's equity, and statement of cash flows for the year ended June 30, 2010; and prepare the balance sheet at June 30, 2010. (Ignore depreciation.)
3. Calculate the current ratio at June 30, 2010.

Solution:

				Shareholders' equity		
	Total Assets	=	Total Liabilities	+	Contributed Capital	+ Retained Earnings
1.	+ 255,000 Cash		+ 55,000 Long-term notes payable		+ 200,000 Common Stock	
2.	(125,000) Cash '+ 125,000 Land and building					
3.	(25,000) Cash '+ 25,000 Office equipment & furniture					
4.	+ 45,500 Computer system		+ 45,500 Accounts payable			
5.	+ 172,000 Cash + 43,000 Accounts receivable					+ 215,000 Service revenue
6.	(80,000) Cash		+ 15,000 Salaries payable			(95,000) Salaries expense
7.	(24,000) Cash '+ 18,000 Prepaid insurance					(6,000) Insurance expense
8.	(20,250) Cash					(20,250) Operating expenses
9.			+ 7,175 Interest payable			(7,175) Interest expense
10.	(20,000) Cash + 20,000 Certificate of Deposit					
11.	(3,200) Cash					(3,200) Dividends
TOTALS	**$406,050**		**$122,675**		**$200,000**	**$83,375**

Wu Web Designs, Inc.
Income Statement
For the year ended June 30, 2010

Service revenue		$ 215,000
Expenses		
Salary expense	$ 95,000	
Insurance expense	6,000	
Operating expenses	20,250	
Interest expense	7,175	
Total expenses		128,425
Net income		$ 86,575

Wu Web Designs, Inc.
Statement of Changes in Shareholders' Equity
For the year ended June 30, 2010

Common stock		
Beginning balance	$ -	
Contributions during the month	200,000	
Ending common stock balance		$ 200,000
Retained earnings		
Beginning balance	-	
+ Net income	86,575	
- Dividends	(3,200)	
Ending retained earnings balance		83,375
Total shareholders' equity		$ 283,375

P2-46B Solution continued:

Wu Web Designs, Inc. Balance Sheet At June 30, 2010		
Assets		
Cash	$	129,550
Short-term investments		20,000
Accounts receivable		43,000
Prepaid insurance		18,000
Total current assets		210,550
Land and building		125,000
Office equipment & furniture		25,000
Computer system		45,500
Total assets	$	406,050
Liabilities and Shareholders' Equity		
Liabilities		
Salaries payable	$	15,000
Interest payable		7,175
Accounts payable		45,500
Total current liabilities		67,675
Long-term notes payable		55,000
Total liabilities		122,675
Shareholders' equity		
Common stock		200,000
Retained earnings		83,375
Total liabilities and shareholders' equity	$	406,050

Wu Web Designs, Inc. Statement of Cash Flows For the year ended June 30, 2010			
Cash from operations:			
Cash collected from customers	$	172,000	
Cash paid for insurance	$	(24,000)	
Cash paid for salary expense		(80,000)	
Cash paid for operating expenses		(20,250)	
Net cash provided by operations			$ 47,750
Cash flows from investing activities			
Purchase of land and building		(125,000)	
Purchase of office equipment & furniture		(25,000)	
Purchase of certificate of deposit		(20,000)	
Net cash used by investing activities			(170,000)
Cash from financing activities:			
Issuance of note payable		55,000	
Issuance of common stock		200,000	
Payment of dividends		(3,200)	
Net Cash from financing activities			251,800
Net increase in cash			129,550
Add beginning cash			-
Cash balance at December 31			$ 129,550

c. Current Ratio:

Current assets/Current liabilities 3.111 = $\frac{\$210,550}{\$67,675}$

The current ratio is a measure of liquidity and indicates a firm's ability to pay short-term debts.

The higher the ratio the more liquid the company is. The current ratio for this company is very high. A current ratio can be too high. Cash makes up a large portion of this company's total current assets. However, a new firm often needs a great deal of cash to get through the first operating cycle.

Financial Statement Analysis

FSA2-1. *Identify items from the balance sheet. (LO 3, 5).* The balance sheets (adapted) for Tootsie Roll Industries, Inc., are shown here.

Tootsie Roll Industries, Inc.
Balance Sheet (adapted)
(in thousands)

	December 31, 2008	December 31, 2007
Assets		
Cash	$ 68,908	$ 57,606
Investments	17,963	41,307
Receivables	34,196	35,284
Inventory	55,584	57,402
Other current assets	11,328	8,127
Net property, plant, and equipment	217,628	201,401
Other noncurrent assets	406,485	411,598
Total assets	$812,092	$812,725
Liabilities and Shareholders' Equity		
Accounts payable	13,885	11,572
Dividends payable	4,401	4,344
Accrued liabilities	40,335	42,056
Deferred income taxes	631	0
Total current liabilities	59,252	57,972
Noncurrent liabilities	118,070	116,523
Total liabilities	177,322	174,495
Contributed capital	509,131	495,197
Retained earnings	142,872	156,752
Other shareholders' equity accounts, net*	(17,233)	(13,719)
Total shareholders' equity	634,770	638,230
Total liabilities and shareholders' equity	$812,092	$812,725

*This is an item you will learn about in a later chapter.

Requirements

1. What were the total current assets at December 31, 2007? December 31, 2008?
2. How are the assets ordered on the balance sheet?
3. What were the total current liabilities at December 31, 2007? December 31, 2008?
4. Calculate the current ratio at December 31, 2007, and December 31, 2008. What information do these numbers provide?

Solution:

1 Total current assets were $187,979,000 and $199,726,000 at December 31, 2008 and 2007, respectively.

2 The assets are listed on the balance sheet in order of liquidity.

3 Total current liabilities were $59,252,000 and $57,972,000 at December 31, 2008 and 2007, respectively.

4

2007	3.45
2008	3.17

These numbers show that Tootsie Roll has plenty of current assets to meet its current obligations.

FSA2-2. *Evaluate liquidity from the balance sheet. (LO 3, 4, 5).* Selected information from the comparative balance sheets for Sears Holdings Corporation is presented here. Although some accounts are not listed, all of the current assets and current liabilities are given.

Sears Holdings Corporation
From the Consolidated Balance Sheets
(dollars in millions)

	January 31, 2009	February 2, 2008
Cash	$1,297	$ 1,622
Accounts receivable	839	744
Inventory	8,795	9,963
Other current assets	485	473
Property, plant, and equipment	8,091	8,863
Accounts payable	3,006	3,487
Other current liabilities	5,506	6,075
Long-term liabilities	7,450	7,168
Total shareholders' equity	9,380	10,667

Requirements

1. Provide the following values at the end of each given fiscal year:
   a. Current assets
   b. Current liabilities
   c. Current ratio
2. Based on your answers in part 1, discuss the change in liquidity between the two years.

Solution:

1.

		At the end of the fiscal year	
		1/31/2009	2/2/2008
		(amounts in millions)	
a	Current assets	$ 11,416	$ 12,802
b	Current liabilities	$ 8,512	$ 9,562
c	Current ratio	1.34	1.34

2. The current ratio is quite stable and is significantly greater than 1.
   The ratio appears sufficiently high for Sears to meets its current obligations.

FSA2-3. *Identify items from the statement of cash flows. (LO 3).* A condensed statement of cash flows for Apple Inc. for the year ended September 27, 2008, is shown here. Use it to answer the questions given after the statement.

Apple Inc.
Statement of Cash Flows (adapted)
For the Year Ended September 27, 2008
(in millions)

Cash and cash equivalents, beginning of the year	$ 9,352
Cash generated by operating activities	9,596
Investing Cash Flows:	
Purchase of short-term investments	(22,965)
Proceeds from maturities of short-term investments	11,804
Proceeds from sales of short-term investments	4,439
Purchase of property, plant, and equipment	(1,091)
Other	(376)
Cash (used in) generated by investing activities	(8,189)
Financing Cash Flows:	
Proceeds from issuance of common stock	483
Other (net)	633
Cash generated by financing activities	1,116
Increase in cash and cash equivalents	2,523
Cash and cash equivalents, end of the year	$11,875

Requirements

1. What was Apple's net cash flow related to operating activities during the year?
2. What was Apple's net cash flow related to investing activities during the year?
3. What was Apple's net cash flow related to financing activities during the year?
4. If you were to look at Apple's balance sheets for the two most recent fiscal years, what amount would be shown on each for cash (and cash equivalents)?

Solution:

1 $9,596 million
2 ($8,189) million
3 $1,116 million
4 The 2007 balance would be $9,352 million; the 2008 balance would be $11,875.

Critical Thinking Problems

Risk and Controls

Look at the information from the Books-A-Million annual report in Appendix A, paying special attention to the notes. What kinds of risks does Books-A-Million face? Use the information in the annual report and your own experience to answer this question.

Solution:

Answers will vary. Sample answer:
Risks faced by Books-A-Million include:
1 Employee theft
2 Theft by customers
3 External threats from e-books (like Kindle)

Ethics

Ken Jones wants to start a small business and has asked his uncle to lend him $10,000. He has prepared a business plan and some financial statements that indicate the business could be very profitable. Ken is afraid his uncle will want some ownership in the company for his investment, but Ken does not want to share what he believes will be a hugely successful company. What are the ethical issues Ken must face as he prepares to present his business plan to his uncle? Do you think he should try to *emphasize* the risks of ownership to his uncle to convince him it would be preferable to be a creditor? Why or why not?

Solution:

Answers will vary. Sample answer:

If Ken is only interested in having his uncle as a creditor and not as an investor, he should be upfront about the issue. He should propose a loan rather than an investment opportunity and he should address only repayment issues in the proposal to his uncle. If his uncle proposes investment instead, he could express a reluctance to share control rather than rewards without being unethical.

If Ken's uncle is interested in ownership and Ken must have the capital, Ken should present both the pros and cons of ownership to his uncle. Ownership means taking greater risks, but standing to gain greater rewards. In extending a loan, the uncle would be exposed to the risk that the loan would not be repaid if the business is not successful, but he would not have the opportunity to earn large returns if the business is successful. Ken should be forthcoming about the specific potential risks and returns.

Group Assignment

Look at the four basic financial statements for Team Shirts in Exhibits 2.5, 2.6, 2.7, and 2.8. Work together to find numbers that show the links between the various financial statements. Then, write a brief explanation of how the statements relate to each other.

Internet Exercise: MSN Money and Merck

MSN Money offers information about companies, industries, people, and related news items. For researching a company, the Web site is a good place to start gathering basic information.

Please go to http://moneycentral.msn.com.

IE2-1. In the *Symbol* box, enter MRK for Merck and Co., Inc.

1. What type of company is Merck?
2. List three products manufactured by Merck.

Solution:

IE 2-1 1 Merck is a pharmaceutical manufacturer.
2 Products manufactured by Merck include Vioxx, Fosamax, and Zocor.

IE2-2. Click on Financial Results, and then on Statements.

1. For the most recent year list the amounts reported for sales, cost of goods sold, and total net income. Does the amount reported for revenue represent cash received from customers during the year? If not, what does it represent? What does the amount reported for cost of goods sold represent? Is Merck a profitable company? How can you tell?
2. For the most recent year list the amounts reported for total assets, total liabilities, and total shareholders' equity. Does the accounting equation hold true? Are assets primarily financed with liabilities or shareholders' equity?
3. Does Merck use accrual-based or cash-based accounting? How can you tell?

Please note: Internet Web sites are constantly being updated. Therefore, if the information is not found where indicated, please explore the Web site further to find the information.

Solution:

IE 2-2 1

	FYE Dec. 31 2008 (in millions)	
Sales	$ 23,850.3	
Cost of goods sold	$ 5,582.5	(Costs, Expenses, and Other Materials and Production)
Net income	$ 7,808.4	

Revenue is not the same as cash received from customers. Revenue is calculated on an accrual basis and includes all sales revenues earned during the period, whether the cash has been collected or not. The balance sheet shows significant receivables.

Cost of goods sold is the cost of manufacturing the pharmaceuticals sold during the period.

Yes, Merck was a profitable company in 2008, earning a net income of $7,808.4 million.

2

	12/31/08 (in millions)
Total assets	$ 47,195.7
Total liabilities	$ 28,437.4
Total shareholders' equity	$ 18,758.3

Yes, total assets = total liabilities + total shareholders' equity.

Merck is financed with more debt than equity.

3 Merck follows the accrual basis of accounting because it is a publicly traded company and must follow GAAP. The balance sheet has receivables and payables, indicating accrual basis accounting.