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 (Google), 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.

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. $950,000 ($357,500 + $592,500)

b. $45,000 ($300,000 – $255,000)

c. $44,325 ($56,200 – $11,875)

E2–2

Amounts in millions:

a. $47,323 ($92,033 – $44,710)

b. $6,075 increase ($3,756 + $2,319)

c. Total assets = $95,789 ($92,033 + $3,756)
Total liabilities = $50,785 ($44,710 + $6,075)
Total stockholders' equity = $45,004 ($47,323 – $2,319)

d. Yes. [$95,789 (total assets) = $50,785 (total liabilities) + $45,004 (total stockholders' equity)]

E2–3

Amounts in millions:

a. $1,533 ($7,837 – $6,304)

b. $112 increase ($223 – $111)

c. Total assets = $7,726 ($7,837 – $111)
Total liabilities = $6,081 ($6,304 – $223)
Total stockholders' equity = $1,645 ($1,533 + $112)

d. Yes. [$7,726 (total assets) = $6,081 (total liabilities) + $1,645 (total stockholders' equity)]

E2–4

(a) $193,437 ($241,272 – $47,835)

(b) $128,249 ($321,686 – $193,437)

(c) $375,319 ($321,686 + $53,633)

(d) $134,047 [($375,319 – $241,272) or ($128,249 + $5,798)]

(e) $244,180 [($221,656 + $22,524) or ($257,143 – $12,963)]

(f) $221,656 [($214,047 + $7,609) or ($244,180 – $22,524)]

(g) $12,963 [($257,143 – $244,180) or ($20,572 – $7,609)]

(h) $20,572 ($43,096 – $22,524)

(i) $214,047 ($257,143 – $43,096)

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)

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 $8,000. 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)
	$ 86,000
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 ($495,000 – $160,000)**		**$ 335,000**
	Deduct stockholders' equity at beginning of year ($333,000 – $118,000)		**(215,000)**
	Increase in stockholders' equity		**$ 120,000**
	Deduct increase due to net income ($90,000 – $39,000)		**(51,000)**
			$ 69,000
	Add dividends		**7,500**
	Additional issuance of common stock	**(a)**	**$ 76,500**
Krypton:	**Stockholders' equity at end of year ($350,000 – $110,000)**		**$ 240,000**
	Deduct stockholders' equity at beginning of year ($250,000 – $130,000)		**(120,000)**
	Increase in stockholders' equity		**$ 120,000**
	Add dividends		**16,000**
			$ 136,000
	Deduct additional issuance of common stock		**(50,000)**
	Increase due to net income		**$ 86,000**
	Add expenses		**64,000**
	Revenue	**(b)**	**$ 150,000**
Fluorine:	**Stockholders' equity at end of year ($90,000 – $80,000)**		**$ 10,000**
	Deduct stockholders' equity at beginning of year ($100,000 – $76,000)		**(24,000)**
	Decrease in stockholders' equity		**$ (14,000)**
	Add decrease due to net loss ($115,000 – $122,500)		**7,500**
			$ (6,500)
	Deduct additional issuance of common stock		**(10,000)**
	Dividends	**(c)**	**$ (16,500)**
Radium:	**Stockholders' equity at end of year ($248,000 – $136,000)**		**$ 112,000**
	Add decrease due to net loss ($112,000 – $128,000)		**16,000**
			$ 128,000
	Add dividends		**60,000**
			$ 188,000
	Deduct additional issuance of common stock		**(40,000)**
	Stockholders' equity at beginning of year		**$ 148,000**
	Add liabilities at beginning of year		**120,000**
	Assets at beginning of year	**(d)**	**$ 268,000**

E2–15

Amounts in millions:

a. $(9,186) = $18,412 – $27,598

b. $(5,568) = –$164 – $15,386 + $9,982

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 (Cash flows from investing activities equal the change in the land account.)

e. $53,000 (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		$180,000
Expenses:		
Salaries expense	$100,000	
Utilities expense	20,000	
Rent expense	16,000	
Interest expense	600	
Miscellaneous expense	3,400	
Total expenses		(140,000)
Net income		$ 40,000

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	150,000		150,000
Net income		40,000	40,000
Dividends		(4,000)	(4,000)
Balances, June 30, 20Y9	$150,000	$36,000	$186,000

E2–19

WEST COAST DREAMS REALTY INC.
Balance Sheet
June 30, 20Y9

Assets		
Cash		$ 86,000
Land		200,000
Total assets		$286,000
Liabilities		
Notes payable		$100,000
Stockholders' Equity		
Common stock	$150,000	
Retained earnings	36,000	
Total stockholders' equity		186,000
Total liabilities and stockholders' equity		$286,000

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	$180,000	
Cash paid for operating activities	(140,000)	
Net cash flows from operating activities		$ 40,000
Cash flows from (used for) investing activities:		
Cash paid for land		(200,000)
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$150,000	
Cash received from issuing notes payable	100,000	
Cash paid as dividends	(4,000)	
Net cash flows from financing activities		246,000
Net increase in cash during June		$ 86,000
Cash as of June 1, 20Y9		0
Cash as of June 30, 20Y9		$ 86,000

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, decrease in assets, and increase in stockholders' equity.

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

PROBLEMS

P2–1

1.

Transaction	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings	
	Balance Sheet									
	Assets			=	Liabilities	+	Stockholders' Equity			
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	c.
Balances	95,000				50,000		30,000		15,000	
d. Rent expense	(2,500)								(2,500)	d.
Balances	92,500				50,000		30,000		12,500	
e. Paid expenses	(1,750)								(1,750)	e.
Balances	90,750				50,000		30,000		10,750	
f. Paid salary expense	(3,250)								(3,250)	f.
Balances	87,500				50,000		30,000		7,500	
g. Paid interest expense	(250)								(250)	g.
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, July 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		$124,000
Expenses:		
Salaries expense	$54,400	
Utilities expense	17,000	
Rent expense	14,000	
Taxes expense	8,600	
Interest expense	960	
Miscellaneous expense	2,040	
Total expenses		(97,000)
Net income		$ 27,000

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	15,000		15,000
Net income		27,000	27,000
Dividends		(3,000)	(3,000)
Balances, Dec. 31, 20Y7	$15,000	$24,000	$39,000

P2–3, Concluded

3. **DUST, SWEEP, REPEAT SERVICES, INC.**
Balance Sheet
December 31, 20Y7

Assets		
Cash		$12,000
Land		43,000
Total assets		$55,000
Liabilities		
Notes payable		$16,000
Stockholders' Equity		
Common stock	$15,000	
Retained earnings	24,000	
Total stockholders' equity		39,000
Total liabilities and stockholders' equity		$55,000

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	$124,000	
Cash paid for operating activities	(97,000)	
Net cash flows from operating activities		$ 27,000
Cash flows from (used for) investing activities:		
Cash paid for land		(43,000)
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$ 15,000	
Cash received from issuing notes payable	16,000	
Cash paid as dividends	(3,000)	
Net cash flows from financing activities		28,000
Net increase in cash during the year		$ 12,000
Cash as of January 1, 20Y7		0
Cash as of December 31, 20Y7		$ 12,000

P2–4

1.

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

Revenues:		
Fees earned		$ 443,000
Expenses:		
Salaries expense	$190,000	
Utilities expense	60,000	
Rent expense	50,000	
Taxes expense	32,500	
Interest expense	3,600	
Miscellaneous expense	6,900	
Total expenses		(343,000)
Net income		$ 100,000

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	$15,000	$ 24,000	$ 39,000
Issued common stock	40,000*		40,000
Net income		100,000	100,000
Dividends		(25,000)	(25,000)
Balances, Dec. 31, 20Y8	$55,000	$ 99,000	$154,000

*$55,000 – $15,000 = $40,000

P2–4, Concluded

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

Assets		
Cash		$ 44,000*
Land		170,000
Total assets		$214,000
Liabilities		
Notes payable		$ 60,000
Stockholders' Equity		
Common stock	$55,000	
Retained earnings	99,000	
Total stockholders' equity		154,000
Total liabilities and stockholders' equity		$214,000

*$214,000 – $170,000 = $44,000

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	$ 443,000	
Cash paid for operating activities	(343,000)	
Net cash flows from operating activities		$ 100,000
Cash flows from (used for) investing activities:		
Cash paid for land		(127,000)*
Cash flows from (used for) financing activities:		
Cash received from issuing common stock	$ 40,000	
Cash received from issuing notes payable	44,000**	
Cash paid for dividends	(25,000)	
Net cash flows from financing activities		59,000
Net increase in cash during the year		$ 32,000
Cash as of Jan. 1, 20Y8		12,000
Cash as of Dec. 31, 20Y8		$ 44,000

*$170,000 – $43,000 = $127,000

**$60,000 – $16,000 = $44,000

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.)**

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 ($180,000 – $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 and the amount of retained earnings that appears on the balance sheet.

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

MBA 2–2

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

MBA 2–3

1.

	Year 1	Year 2	Increase (Decrease)
Revenue	100.0%	100.0%	n/a
Operating expenses:			
Fuel	(12.9)%	(13.9)%	1.0%
Aircraft related	(24.8)	(25.7)	0.9
Selling and general	(39.8)	(40.1)	0.3
Other expenses	(5.0)	(5.5)	0.5
Total operating expenses	(82.5)%	(85.2)%	2.7%
Operating income	17.5%	14.8%	(2.7)%

2. Delta's operating income as a percent of revenue decreased 2.7% from 17.5% in Year 1 to 14.8% in Year 2. Fuel expenses increased 1.0% from 12.9% in Year 1 to 13.9% in Year 2. Aircraft related expenses such as landing fees, maintenance, and depreciation increased 0.9% from 24.8% in Year 1 to 25.7% in Year 2. Selling and general expenses increased 0.3% and other expenses increased 0.5%. Overall, it appears that increasing fuel and aircraft related costs were the primary cause of the decrease in operating income.

MBA 2–4

1.

	Year 1	Year 2	Increase (Decrease)
Revenue	100.0%	100.0%	n/a
Operating expenses:			
Fuel	(17.9)%	(18.6)%	0.7%
Aircraft related	(18.1)	(17.5)	(0.6)
Selling and general	(33.3)	(34.6)	1.3
Other expenses	(12.3)	(12.7)	0.4
Total operating expenses	(81.6)%	(83.4)%	1.8%
Operating income	18.4%	16.6%	(1.8)%

2. Southwest's operating income decreased 1.8% as a percent of revenue from 18.4% in Year 1 to 16.6% in Year 2. The decrease was caused primarily by an increase of 1.3% in selling and general expenses and an increase in fuel expenses of 0.7%. These increases were offset by a decrease in aircraft related expenses, such as landing fees and maintenance costs, of 0.6%.

MBA 2–5

Southwest's operating income as a percent of revenue decreased by 1.8% compared to Delta's decrease of 2.7%. The difference in operating results does not appear to be attributable to one item in particular. Southwest's increase in selling and general expenses of 1.3% was the major contributing factor to its percentage decrease in operating income. Delta's increase in fuel and aircraft-related expenses of 2.0% was the major contributing factor to its decrease in operating income.

MBA 2–6

1.

	Year 1	Year 2	Increase (Decrease)
Sales	100.0%	100.0%	n/a
Cost of goods sold	(63.5)	(61.1)	(2.4)%
Gross profit	36.5%	38.9%	2.4%
Selling and administrative expenses	(25.8)	(23.8)	(2.0)
Operating income	10.7%	15.1%	4.4%

2. **Kellogg's operating income as a percent of sales increased by 4.4% from 10.7% to 15.1%. This increase was caused by the decrease in cost of goods sold of 2.4% and the decrease in selling and administrative expenses of 2.0% as a percentage of sales.**

MBA 2–7

1.

	Year 1	Year 2	Increase (Decrease)
Sales	100.0%	100.0%	n/a
Cost of goods sold	(64.4)	(65.5)	1.1%
Gross profit	35.6%	34.5%	(1.1)%
Selling and administrative expenses	(17.9)	(17.5)	(0.4)
Operating income	17.7%	17.0%	(0.7)%

2. **General Mills' operating income as a percent of sales decreased by 0.7% from 17.7% to 17.0%. This decrease was caused by the increase in cost of goods sold of 1.1%, which was only partially offset by the decrease in selling and administrative expenses of 0.4%.**

MBA 2–8

In Year 1, Kellogg's operating income as a percent of sales was 10.7% compared to General Mills' 17.7%. In Year 2, Kellogg's operating income as a percentage of sales increased by 4.4%; however, General Mills' income as a percentage of sales decreased by 0.7%. This difference was caused by Kellogg's decrease of 2.4% in cost of goods sold compared to General Mills' increase of 1.1% in cost of goods sold. In Year 2, Kellogg's selling and administrative expenses decreased by 2.0% compared to General Mills' decrease of 0.4%. Thus, Kellogg's Year 2 operating performance has improved relative to General Mills' operating performance.

MBA 2–9

1.

	Year 1	Year 2	Increase (Decrease)
Current assets:			
Cash	6.4%	5.4%	(1.0)%
Marketable securities	14.5	14.4	(0.1)
Accounts receivable	4.9	4.8	(0.1)
Inventory	0.6	1.3	0.7
Other	6.8	8.4	1.7
Total current assets	33.2%	34.3%	1.1%
Long-term assets:			
Long-term marketable securities	53.0%	51.9%	(1.1)%
Property, plant, and equipment	8.4	9.0	0.6
Other long-term assets	5.4	4.8	(0.6)
Total long-term assets	66.8%	65.7%	(1.1)%
Total assets	100.0%	100.0%	
Current liabilities:			
Accounts payable and similar liabilities	11.6%	13.1%	1.5%
Current portion of long-term debt	1.1	1.7	0.6
Other	11.9	12.1	0.2
Total current liabilities	24.6%	26.9%	2.3%
Long-term liabilities	35.6	37.4	1.8
Total liabilities	60.2%	64.3%	4.1%
Stockholders' equity:			
Common stock	9.7%	9.5%	(0.2)%
Retained earnings	29.9	26.2	(3.7)
Other items	0.2	0.0	(0.2)
Total stockholders' equity	39.8%	35.7%	(4.1)%
Total liabilities and stockholders' equity	100.0%	100.0%	

2. Apple's current assets as a percent of total assets increased slightly by 1.1% from 33.2% to 34.3% with other current assets increasing the most by 1.7%. At the same time, long-term assets declined by 1.1%. Apple's total liabilities increased by 4.1% from 60.2% to 64.3% with long-term liabilities increasing the most by 1.8%. This is explained by Apple issuing over $21 billion in long-term notes during Year 2.

CASES

Case 2–1

1. From our discussions 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 operating activities	negative	positive	positive
Net cash flows from investing activities	negative	negative	negative
Net cash flows from financing activities	positive	positive	positive

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.

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 May 26, 2019, from Yahoo.com's finance Web site.

1. $178.97 (See opening page for AAPL)

2. $142.00 to $182.13 (See opening page for AAPL)

3. $233.47 (See Statistics)

4. 178,930 net shares were purchased in the last 6 months ending May 26, 2019. (See Insider Transactions under Holders)

5. Timothy D. Cook; he is 58 years old. (See Profile)

6. $15,680,000 (See Profile)

7. $2.92 (See Statistics)

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

   Average broker recommendation is 2.2 (See Analysis)

9. $77,434 million (See Financials: Cash Flows)

10. 25.34% (See Statistics)