Introductory Financial Accounting for Business 1st edition Edmonds Solutions Manual

SKU: 9781260299441-SOLUTIONS

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SOLUTIONS TO EXERCISES – SERIES A – CHAPTER 2

EXERCISE 2-1A

a.

The Ramires, Incorporated
Horizontal Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
Event	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings						
1	56,000	+	NA	=	NA	+	56,000	+	NA	NA	–	NA	=	NA	56,000 FA
2	52,000	+	NA	=	NA	+	NA	+	52,000	52,000	–	NA	=	52,000	52,000 OA
3	(27,000)	+	NA	=	NA	+	NA	+	(27,000)	NA	–	27,000	=	(27,000)	(27,000) OA
4	15,000	+	NA	=	15,000	+	NA	+	NA	NA	–	NA	=	NA	15,000 FA
5	(40,000)	+	40,000	=	NA	+	NA	+	NA	NA	–	NA	=	NA	(40,000) IA
6	(1,000)	+	NA	=	NA	+	NA	+	(1,000)	NA	–	NA	=	NA	(1,000) FA
	55,000	+	40,000	=	15,000	+	56,000	+	24,000	52,000	–	27,000	=	25,000	55,000 NC

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EXERCISE 2-1A (cont.)

b.

The Ramires, Incorporated Income Statement For the Period Ended December 31, Year 1	
Revenue	$52,000
Expenses	(27,000)
Net Income	$25,000

The Ramires, Incorporated Statement of Changes in Stockholders' Equity For the Period Ended December 31, Year 1		
Beginning Common Stock	$ -0-	
Plus: Common Stock Issued	56,000	
Ending Common Stock		$56,000
Beginning Retained Earnings	$-0-	
Plus: Net Income	25,000	
Less: Dividends	(1,000)	
Ending Retained Earnings		24,000
Total Stockholders' Equity		$80,000

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EXERCISE 2-1A b. (cont.)

The Ramires, Incorporated Balance Sheet As of December 31, Year 1		
Assets		
Cash	$55,000	
Land	40,000	
Total Assets		$95,000
Liabilities		
Notes Payable		$15,000
Stockholders' Equity		
Common Stock	$56,000	
Retained Earnings	24,000	
Total Stockholders' Equity		$80,000
Total Liabilities and Stockholders' Equity		$95,000

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EXERCISE 2-1A b. (cont.)

The Ramires, Incorporated Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flows From Operating Activities:		
Cash Receipts from Customers	$52,000	
Cash Payments for Expenses	(27,000)	
Net Cash Flow from Operating Activities		$25,000
Cash Flows From Investing Activities:		
Cash Payment for Land	$(40,000)	
Net Cash Flow from Investing Activities		$(40,000)
Cash Flows From Financing Activities:		
Cash Receipts from Stock Issue	$56,000	
Cash Receipts from Borrowed Funds	15,000	
Cash Dividends	(1,000)	
Net Cash Flow from Financing Activities		$70,000
Net Increase in Cash		55,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$55,000

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EXERCISE 2-2A

a.

The Candle Shop
Horizontal Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows	
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.		
Event	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings							
1	I	+	NA	=	NA	+	I	+	NA	NA	–	NA	=	NA	I	FA
2	D	+	NA	=	NA	+	NA	+	D	NA	–	NA	=	NA	D	FA
3	D	+	NA	=	NA	+	NA	+	D	NA	–	I	=	D	D	OA
4	I	+	NA	=	I	+	NA	+	NA	NA	–	NA	=	NA	I	FA
5	I	+	NA	=	NA	+	NA	+	I	I	–	NA	=	I	I	OA
6	D	+	I	=	NA	+	NA	+	NA	NA	–	NA	=	NA	D	IA
7	NA	+	NA	=	NA	+	NA	+	NA	NA	–	NA	=	NA	NA	

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EXERICSE 2-3A

a. Missing items are determined as follow:

(a) $200,000; Since the cash flow column shows that this event was financing activity, we can infer that the company either borrowed money or issued stock. Since the model shows that liabilities were not affected, we conclude that the common stock account increased by $200,000.

(b) NA; Since issuing common stock (see answer to (a) above), does not affect the revenue account, the answer is not affected (NA).

(c) NA; Since issuing common stock (see answer to (a) above), does not affect net income, the answer is not affected (NA).

(d) NA; Since assets and liabilities increased, we infer that the company borrowed money. Borrowing money does not affect net income.

(e) FA; Since assets and liabilities increased, we infer that the company borrowed money. Borrowing money is a financing activity (FA).

(f) 500,000; Since cash decreased and no other balance sheet account other than the land account was affected, the company must have purchased land which would cause the land account to increase by 500,000.

(g) IA; Purchasing land (see answer to (f) above) is in investing activity (IA).

(h) 95,000; The income statement shows $95,000 of revenue. Recognizing revenue increases the cash and retained earning accounts on the balance sheet.

(i) 95,000; The income statement shows $95,000 of revenue. Recognizing revenue increases the cash and retained earning accounts on the balance sheet.

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EXERCISE 2-3A a. (cont).

(j) (65,000); The statement of cash flows shows that the $65,000 cash outflow was an operating activity. Therefore, we conclude that this is an expense item that will act to reduce the amount of retained earnings shown in the balance sheet.

(k) 65,000; The statement of cash flows shows that the $65,000 cash outflow was an operating activity. Therefore, we conclude that this is an expense item that will act to increase amount of expenses shown in the income statement.

(l) FA; Since the event decreases cash and retained earnings on the balance sheet; and does not affect the income statement, we conclude that this was a dividend payment which is a financing activity (FA)

(m) 68,000; This amount is determined by totaling the vertical column.

(n) 95,000; This amount is determined by totaling the vertical column.

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EXERCISE 2-3A a. (cont.)

Completed Horizontal Statements Model

The Frame Shop (TFS)
Horizontal Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings						
Beg.	0	+	0	=	0	+	0	+	0	0	–	0	=	0	NA
1	200,000	+	NA	=	NA	+	200,000	+	NA	NA	–	NA	=	NA	200,000 FA
2	350,000	+	NA	=	350,000	+	NA	+	NA	NA	–	NA	=	NA	350,000 FA
3	(500,000)	+	500,000	=	NA	+	NA	+	NA	NA	–	NA	=	NA	(500,000) IA
4	95,000	+	NA	=	NA	+	NA	+	95,000	95,000	–	NA	=	95,000	95,000 OA
5	(65,000)	+	NA	=	NA	+	NA	+	(65,000)	NA	–	65,000	=	(65,000)	(65,000) OA
6	(12,000)	+	NA	=	NA	+	NA	+	(12,000)	NA	–	NA	=	NA	(12,000) FA
	68,000	+	500,000	=	350,000	+	200,000	+	18,000	95,000	–	65,000	=	30,000	68,000 NC

b. $568,000 Total Assets (Cash $68,000 + Land $500,000)

c. $30,000 Net Income (Revenue $95,000 – Expenses $65,000)

d. $538,000 Net Cash Flow from Financing Activities ($200,000 + $350,000 - $12,000)

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EXERCISE 2-4A

Holloway Company
Effect of Events on the Year 1 Financial Statements

	Assets			=	Liabilities	+	Stockholders' Equity		
Event	Cash	+	Accounts Rec.	=		+	Common Stock	+	Retained Earnings
Earned Revenue	NA	+	18,000	=	NA	+	NA	+	18,000
Coll. Acct. Rec.	14,000	+	(14,000)	=	NA	+	NA	+	NA
Ending Balance	14,000	+	4,000	=	-0-	+	-0-	+	18,000

a. **Accounts Receivable: $18,000 – $14,000 = $4,000**

b. **$18,000 Net Income**

c. **$14,000 cash collected from accounts receivable.**

d. **$18,000**

e. **$18,000 of revenue was earned but only $14,000 of it was collected.**

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EXERCISE 2-5A

The Containers Inc.
Horizontal Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
Event	Cash	+	Accts. Rec	=	Notes Payable	+	Common Stock	+	Retained Earnings						
1	42,000	+	NA	=	NA	+	42,000	+	NA	NA	–	NA	=	NA	42,000 FA
2	NA	+	25,000	=	NA	+	NA	+	25,000	25,000	–	NA	=	25,000	NA
3	(18,000)	+	NA	=	NA	+	NA	+	(18,000)	NA	–	18,000	=	(18,000)	(18,000) OA
4	10,000	+	NA	=	10,000	+	NA	+	NA	NA	–	NA	=	NA	10,000 FA
5	22,000	+	(22,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	22,000 OA
6	(1,000)	+	NA	=	NA	+	NA	+	(1,000)	NA	–	NA	=	NA	(1,000) FA
	55,000	+	3,000	=	10,000	+	42,000	+	6,000	25,000	–	18,000	=	7,000	55,000 NC

a. Accounts receivable will appear as an "asset" on the December 31, Year 1 balance sheet.

b. $3,000. Total from the accounts receivable column in the horizontal statements model.

c. $7,000. Total from the net income column in the horizontal statements model.

d. $4,000. Net cash flow from operating activities ($22,000 - $18,000).

e. Cash flow from operating activities and net income are different in most cases, because there is a time gap between when revenue is earned and cash is collected. When a company earns revenue on account, this amount is reflected in net income but will not be reflected on the cash flow statement until the cash is collected.

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EXERCISE 2-6A

Troy Company Horizontal Statements Model for Year 1																	
	Balance Sheet										Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity				Revenue	–	Expense	=	Net Inc.	
Event	Cash	+	Accts. Rec	=	Accts. Payable	+	Common Stock	+	Retained Earnings							
1	15,000	+	NA	=	NA	+	NA	+	15,000		15,000	–	NA	=	15,000	15,000 OA
2	NA	+	NA	=	12,000	+	NA	+	(12,000)		NA	–	12,000	=	(12,000)	NA
3	(8,000)	+	NA	=	(8,000)	+	NA	+	NA		NA	–	NA	=	NA	(8,000) OA
	7,000	+	0	=	4,000	+	0	+	3,000		15,000	–	12,000	=	3,000	7,000 NC

a. $4,000. Total from the accounts payable column in the horizontal statements model.

b. $12,000. Total from the expenses column in the horizontal statements model.

c. $7,000. Total cash flow from operating activities.

d. $3,000. Total from the retained earnings column in the horizontal statements model.

e. Cash flow from operating activities and expenses are different in most cases, because there is a time gap between when an expense is incurred and when cash is paid for that expense. When a company incurs an expense, this amount is reflected in expenses on the income statement but will not impact the cash flow statement until the cash is paid.

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EXERCISE 2-7A

a.

Chung Corporation Accounting Equation – Year 1								
Event	Assets	=	Liabilities	+	Stockholders' Equity		
	Cash	=	Salaries Payable	+	Common Stock	+	Retained Earnings
Earned Rev.	8,000		NA		NA		8,000
Accrued Sal.	NA		5,000		NA		(5,000)
Ending Bal.	8,000	=	5,000	+	-0-	+	3,000

Chung Corporation Balance Sheet As of December 31, Year 1		
Assets		
Cash	$8,000	
Total Assets		$8,000
Liabilities		
Salaries Payable	$5,000	
Total Liabilities		$5,000
Stockholders' Equity		
Retained Earnings	$3,000	
Total Stockholders' Equity		3,000
Total Liab. and Stockholders' Equity		$8,000

b.

Computation of Net Income	
Revenue	$8,000
Less: Expenses	(5,000)
Net Income	$3,000

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EXERCISE 2-7A (cont.)

c.

Cash Flow from Operating Activities	
Cash from Revenue	$8,000
Net Cash Flow from Operating Act.	$8,000

d. The salary expense is deducted from revenue in computing net income, but it has not been paid. This creates a difference of $5,000 between net income and cash flow from operating activities. The revenue is the same because it has been earned and collected.

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EXERCISE 2-8A

a.

Milea Inc.
General Ledger Accounts
For the Year Ended December 31, Year 1

	Assets		=	Liabilities	+	Stockholders' Equity		
Event	Cash	Acct. Rec.	=	Salaries Pay.	+	Common Stock	Retained Earn.	Acct. Title for RE
1.	20,000		=		+	20,000		
2.		56,000	=		+		56,000	Revenue
3.	(2,500)		=		+		(2,500)	Util. Exp.
4.	48,000	(48,000)	=		+			
5.			=	10,000	+		(10,000)	Sal. Exp.
6.	(2,000)		=		+		(2,000)	Dividends
Totals	63,500	8,000	=	10,000	+	20,000	41,500	

b.

Milea Inc.
Income Statement
For the Year Ended December 31, Year 1

Revenue		$56,000
Expenses		
Utility Expense	$ 2,500	
Salaries Expense	10,000	
Total Expenses		(12,500)
Net Income		$43,500

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EXERCISE 2-8A b. (cont.)

Milea Inc. Statement of Changes in Stockholders' Equity For the Year Ended December 31, Year 1		
Beginning Common Stock	$ -0-	
Plus: Common Stock Issued	20,000	
Ending Common Stock		$20,000
Beginning Retained Earnings	-0-	
Plus: Net Income	$43,500	
Less: Dividends	(2,000)	
Ending Retained Earnings		41,500
Total Stockholders' Equity		$61,500

Milea Inc. Balance Sheet As of December 31, Year 1		
Assets		
Cash	$63,500	
Accounts Receivable	8,000	
Total Assets		$71,500
Liabilities		
Salaries Payable	$10,000	
Total Liabilities		$10,000
Stockholders' Equity		
Common Stock	$20,000	
Retained Earnings	41,500	
Total Stockholders' Equity		61,500
Total Liab. and Stockholders' Equity		$71,500

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EXERCISE 2-8A b. (cont.)

Milea Inc. Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flow From Operating Activities		
Cash Received from Customers	$48,000	
Cash Paid for Expenses	(2,500)	
Net Cash Flow from Operating Act.		$45,500
Cash Flow From Investing Activities		-0-
Cash Flow From Financing Activities		
Issue of Stock	$20,000	
Paid Dividends	(2,000)	
Net Cash Flow from Financing Act.		18,000
Net Change in Cash		63,500
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$63,500

c. Net income is the difference between services performed and expenses incurred, regardless of the cash collected or paid. Cash flow from operating activities is the difference between cash collected and paid for operating activities. There was $56,000 of income earned, but only $48,000 collected and $12,500 of expenses incurred, but there was only $2,500 paid.

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EXERCISE 2-9A

a.

Lewis and Harper
Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of
	Assets			=	Liabilities			+	S. Equity	Rev.	–	Exp.	=	Net Inc.	Cash Flows
Event	Cash	+	Accts. Rec.	=	Acct. Payable	+	Sal. Pay.	+	Retained Earn.						
1.	NA	+	70,000	=	NA	+	NA	+	70,000	70,000	–	NA	=	70,000	NA
2.	40,000	+	NA	=	NA	+	NA	+	40,000	40,000	–	NA	=	40,000	40,000 OA
3.	NA	+	NA	=	36,000	+	NA	+	(36,000)	NA	–	36,000	=	(36,000)	NA
4.	(10,000)	+	NA	=	NA	+	NA	+	(10,000)	NA	–	10,000	=	(10,000)	(10,000) OA
5.	47,000	+	(47,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	47,000 OA
6.	(16,000)	+	NA	=	(16,000)	+	NA	+	NA	NA	–	NA	=	NA	(16,000) OA
7.	(8,000)	+	NA	=	NA	+	NA	+	(8,000)	NA	–	NA	=	NA	(8,000) FA
8.	NA	+	NA	=	NA	+	2,000	+	(2,000)	NA	–	2,000	=	(2,000)	NA
Totals	53,000	+	23,000	=	20,000	+	2,000	+	54,000	110,000	–	48,000	=	62,000	53,000 NC

b. Total assets: $76,000 ($53,000 + $23,000)
c. $23,000
d. $20,000
e. Accounts Receivable (an asset) is an amount owed to Lewis and Harper: $23,000; Accounts Payable (a liability) is an amount that Lewis and Harper owe: $20,000
f. $62,000
g. $61,000 ($40,000 – $10,000 + $47,000 – $16,000)

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EXERCISE 2-10A

a. & c.

Event	Revenue	Expense	Statement of Cash Flows
1.	NA	NA	$40,000 FA
2.	$82,000	NA	NA
3.	NA	NA	(6,000) FA
4.	NA	NA	76,000 OA
5.	NA	$53,000	(53,000) OA
6.	19,000	NA	19,000 OA
7.	NA	3,500	NA

b.

Computation of Net Income	
Revenue	$101,000
Less: Expenses	(56,500)
Net Income	$44,500

d.

Cash Flow from Operating Activities	
Cash from Revenue	$95,000
Cash paid for expenses	(53,000)
Net Cash Flow from Operating Act.	$42,000

e. The balance of Retained Earnings on the Year 1 Balance Sheet will be the amount of Net Income, $44,500 minus $6,000 of dividends that were paid during the year = $38,500. There was no beginning balance in Retained Earnings.

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EXERCISE 2-11A

Lee, Inc. Effect of Events on the General Ledger Accounts									
	Assets			=	Liabilities	+	Stockholders' Equity		
Event	Cash	Accounts Receivable	Land	=	Accounts Payable	+	Com. Stock	+	Retained Earnings
1. Sales on Account		62,000							62,000
2. Coll. Accts. Rec.	51,000	(51,000)							
3. Incurred Expense					39,000				(39,000)
4. Pd. Acc. Pay.	(31,000)				(31,000)				
5. Issue of Stock	40,000						40,000		
6. Purchase Land	(21,000)		21,000						
Totals	39,000	11,000	21,000	=	8,000	+	40,000	+	23,000

a. Revenue recognized, $62,000.

b. Cash flow from revenue, $51,000.

c. Revenue, $62,000, less operating expenses, $39,000 = $23,000 net income.

d. Accounts receivable collected, $51,000, less cash paid for expenses, $31,000 = $20,000 cash flow from operating activities.

e. Income of $62,000 was earned, but only $51,000 was collected (a difference of $11,000); operating expenses incurred were $39,000 but only $31,000 was paid during the period (a difference of $8,000). Consequently, net income is $3,000 more than cash flow from operating activities.

f. $21,000 cash outflow for the purchase of land.

g. $40,000 cash inflow from the issue of common stock.

h. Total assets = $71,000 ($39,000 + $11,000 + $21,000)
Total liabilities = $8,000
Total equity = $63,000 ($40,000 + $23,000)

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EXERCISE 2-12A

a. **Examples of expenses that would be matched directly with revenue:**
   Sales commissions
   Salaries expense

b. **An example of a period cost that is difficult to match with revenue:**
   Advertising expense - A company cannot be certain when dollars spent for advertising will produce benefits.

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EXERCISE 2-13A

a. $8,000 x 6% = $480; $480 x 5/12 = $200

b. $-0-, no interest was paid in Year 1; $480 of interest will be paid in Year 2.

c.

Bradley Company
Statements Model for Year 1

Event	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets	=	Liabilities			+	Stockholders' Equity			Rev.	−	Exp.	=	Net Inc.	
No.	Cash	=	Notes Payable	+	Int. Payable	+	Common Stock	+	Ret. Earn.						
1.	I	=	NA	+	NA	+	NA	+	I	I	−	NA	=	I	I OA
2.	I	=	I	+	NA	+	NA	+	NA	NA	−	NA	=	NA	I FA
3.	NA	=	NA	+	I	+	NA	+	D	NA	−	I	=	D	NA

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EXERCISE 2-14A

a. **Interest expense recognized for Year 1: $80,000 x 8% = $6,400; $6,400 x 7/12 = $3,733 (rounded)**

b.

Leach Company Accounting Equation for Year 1									
	Assets	=	Liabilities			+	Equity		
Event	Cash		Note Payable	+	Interest Payable		Common Stock	+	Retained Earnings
Note	80,000	=	80,000	+	NA	+	NA		NA
Adj.	NA		NA		3,733		NA		(3,733)

See the adjusting entry in the accounting equation above (liabilities increase, equity decreases).

c. **$-0-. All interest will be paid at maturity, June 1, Year 2, for this note payable.**

d. **$3,733**

e. **$6,400 ($80,000 x 8%). All interest will be paid when the note payable matures.**

f. **$2,667 ($80,000 x 8% x 5/12) or ($6,400 – $3,733 = $2,667)**

g. **$-0-**

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EXERCISE 2-15A

Solve for "X" in the following scenarios:

a.

X Co. Accounts Receivable Summary		
Beginning AR Balance	$4,500	
Increase in AR from Sales	69,400	
Reduction in AR from Collections	(68,200)	
Endings Accounts Receivable Balance	$5,700	(X)

b.

X Co. Accounts Receivable Summary		
Beginning AR Balance	$4,300	(X)
Increase in AR from Sales	62,200	
Reduction in AR from Collections	(63,100)	
Endings Accounts Receivable Balance	$3,400	

c.

X Co. Accounts Receivable Summary		
Beginning AR Balance	$9,700	
Increase in AR from Sales	99,700	
Reduction in AR from Collections	(99,100)	(X)
Endings Accounts Receivable Balance	$10,300	

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EXERCISE 2-15A a. (cont.)

d.

X Co. Accounts Receivable Summary		
Beginning AR Balance	$22,000	
Increase in AR from Sales	108,300	(X)
Reduction in AR from Collections	(109,000)	
Endings Accounts Receivable Balance	$21,300	

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EXERCISE 2-16A

Solve for "X" in the following scenarios:

a.

X Co. Accounts Payable Summary		
Beginning accounts payable balance	$4,700	
Plus: Expenses incurred on account	67,600	
Minus: Payment of accounts payable	(68,900)	
Ending accounts payable balance	$3,400	(X)

b.

X Co. Accounts Payable Summary		
Beginning accounts payable balance	$3,000	(X)
Plus: Expenses incurred on account	66,400	
Minus: Payment of accounts payable	(64,100)	
Ending accounts payable balance	$5,300	

c.

X Co. Accounts Payable Summary		
Beginning accounts payable balance	$4,100	
Plus: Expenses incurred on account	67,600	
Minus: Payment of accounts payable	(66,900)	(X)
Ending accounts payable balance	$4,800	

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EXERCISE 2-16A a. (cont.)

d.

X Co. Accounts Payable Summary		
Beginning accounts payable balance	$7,700	
Plus: Expenses incurred on account	79,400	(X)
Minus: Payment of accounts payable	(77,300)	
Ending accounts payable balance	$9,800	

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EXERCISE 2-17A

a. Solve for "X"

Harbert Inc. Accounts Receivable Summary		
Beginning AR Balance	$12,000	
Increase in AR from Sales	70,500	(X)
Reduction in AR from Collections	(72,000)	
Endings Accounts Receivable Balance	$10,500	

b. $7,500. Revenue ($70,500) minus expenses ($63,000).

c. $9,000. Cash inflow from AR collections ($72,000) minus cash expenses ($63,000).

d. Cash flow from operating activities and net income are different in most cases, because there is a time gap between when revenue is earned and cash is collected. When a company earns revenue on account, this amount is reflected in net income but will not be reflected on the cash flow statement until the cash is collected.

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EXERCISE 2-18A

a. Solve for "X"

Kincaid Inc. Accounts Payable Summary		
Beginning accounts payable balance	$2,000	
Plus: Expenses incurred on account	63,000	(X)
Minus: Payment of accounts payable	(40,000)	
Ending accounts payable balance	$25,000	

b. $22,000. Revenue ($85,000) minus expenses ($63,000).

c. $45,000. Cash inflow from sales ($85,000) minus cash outflow for expenses ($40,000).

d. Cash flow from operating activities and expenses are different in most cases, because there is a time gap between when an expense is incurred and when cash is paid for that expense. When a company incurs an expense, this amount is reflected in expenses on the income statement but will not impact the cash flow statement until the cash is paid.

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EXERCISE 2-19A

The six principles of the AICPA Code of Professional Conduct and a brief explanation is as follows:

<u>Responsibilities Principle</u>

In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

<u>The Public Interest Principle</u>

Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

<u>Integrity Principle</u>

To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

<u>Objectivity and Independence Principle</u>

A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

<u>Due Care Principle</u>

A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.

<u>Scope and Nature of Services Principle</u>

A member in public practice should observe the principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

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SOLUTIONS TO PROBLEMS – SERIES A – CHAPTER 2

PROBLEM 2-20A

a.

Maben Company
Horizontal Statements Model for Year 1

Event	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings	Revenue	–	Expense	=	Net Inc.	Statement of Cash Flows	
	Balance Sheet									**Income Statement**						
	Assets			=	Liab.	+	Stockholders' Equity									
1	30,000	+	NA	=	NA	+	30,000	+	NA	NA	–	NA	=	NA	30,000	FA
2	40,000	+	NA	=	40,000	+	NA	+	NA	NA	–	NA	=	NA	40,000	FA
3	48,000	+	NA	=	NA	+	NA	+	48,000	48,000	–	NA	=	48,000	48,000	OA
4	(25,000)	+	NA	=	NA	+	NA	+	(25,000)	NA	–	25,000	=	(25,000)	(25,000)	OA
5.	(1,000)	+	NA	=	NA	+	NA	+	(1,000)	NA	–	NA	=	NA	(1,000)	FA
6.	20,000	+	NA	=	NA	+	20,000	+	NA	NA	–	NA	=	NA	20,000	FA
7.	(10,000)	+	NA	=	(10,000)	+	NA	+	NA	NA	–	NA	=	NA	(10,000)	FA
8.	(53,000)	+	53,000	=	NA	+	NA	+	NA	NA	–	NA	=	NA	(53,000)	IA
9.	NA	+	NA	=	NA	+	NA	+	NA	NA	–	NA	=	NA		NA
Total	49,000	+	53,000	=	30,000	+	50,000	+	22,000	48,000	–	25,000	=	23,000	49,000	NC

b. Total Assets = $49,000 + $53,000 = $102,000

c.

Sources of Assets	
1. Issue of stock	$ 30,000
2. Cash from loan	40,000
3. Cash from revenue	48,000
6. Issue of stock	20,000
Total Sources of Assets	$138,000

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PROBLEM 2-20A (cont.)

d. **Net income amounts to $23,000 (see part a.) Dividends are not expenses and do not appear on the income statement.**

e.

Operating Activities:	
Cash from revenue	$48,000
Cash paid for expenses	(25,000)
Net Cash Flow from Operating Activities	$23,000

Investing Activities:	
Cash paid to purchase land	$(53,000)
Net Cash Flow from Investing Activities	$(53,000)

Financing Activities:	
Cash from stock issue ($30,000 + $20,000)	$50,000
Cash from loan	40,000
Paid cash dividend	(1,000)
Cash paid on loan principal	(10,000)
Net Cash Flow from Financing Activities	$79,000

f. **Percentage of assets is provided as follows:**

Investors	($50,000 ÷ $102,000)	49.0%
Creditors	($30,000 ÷ $102,000)	29.4%
Earnings	($22,000 ÷ $102,000)	21.6%

g. **Zero. The revenue is recorded in a Revenue account not in the Retained Earnings account. The balance in the Revenue account is transferred to Retained Earnings at the end of the accounting period through the closing process.**

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PROBLEM 2-21A

Event No.	Description
6	Incurred cash expenses.
2	Earned revenue on account.
4	Earned cash revenue.
1	Issued common stock for cash.
8	Paid a cash dividend.
5	Collected cash from customer accounts receivable.
7	Used cash to pay off accounts payable.
3	Incurred expenses on account.

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PROBLEM 2-22A

Wadell Company Statements Model for Year 2																	
	Balance Sheet											Income Statement					Statement of
	Assets					=	Liab.	+	S. Equity			Rev.	–	Exp.	=	Net Inc.	Cash Flows
Date	Cash	+	Accts. Rec.	+	Land	=	Accts. Pay.	+	Common Stock		Retained Earn.						
Beg.	35,000	+	9,000	+	51,000	=	7,500	+	40,000		47,500	NA	–	NA	=	NA	35,000
1/1	20,000	+	NA	+	NA	=	NA	+	20,000		NA	NA	–	NA	=	NA	20,000 FA
3/1	(2,000)	+	NA	+	NA	=	NA	+	NA		(2,000)	NA	–	NA	=	NA	(2,000) FA
4/1	(15,000)	+	NA	+	15,000	=	NA	+	NA		NA	NA	–	NA	=	NA	(15,000) IA
5/1	(5,500)	+	NA	+	NA	=	(5,500)	+	NA		NA	NA	–	NA	=	NA	(5,500) OA
9/1	30,000	+	NA	+	(30,000)	=	NA	+	NA		NA	NA	–	NA	=	NA	30,000 IA
12/31	NA	+	58,000	+	NA	=	NA	+	NA		58,000	58,000	–	NA	=	58,000	NA
12/31	46,000	+	(46,000)	+	NA	=	NA	+	NA		NA	NA	–	NA	=	NA	46,000 OA
12/31	NA	+	NA	+	NA	=	28,000	+	NA		(28,000)	NA	–	28,000	=	(28,000)	NA
12/31	NA	+	NA	+	NA	=	NA	+	NA		NA	NA	–	NA	=	NA	NA
Totals	108,500	+	21,000	+	36,000	=	30,000	+	60,000		75,500	58,000	–	28,000	=	30,000	108,500

a. $36,000. Total of the land column in the horizontal statements model.

b. $40,500. Cash inflows of $46,000 minus cash outflows of $5,500.

c. $30,000. Total of the liabilities column in the horizontal statements model.

d. $15,000. Cash inflow from the sale of land ($30,000) minus cash outflow from the purchase of land ($15,000).

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PROBLEM 2-22A (cont.)

e. **$28,000. Total of the expenses column in the horizontal statements model.**

f. **$58,000. Total of the revenue column in the horizontal statements model.**

g. **$18,000. Cash inflow from issuance of common stock ($20,000) minus cash outflow from dividend ($2,000).**

h. **$30,000. Revenues ($58,000) minus expenses ($28,000).**

i. **$75,500. Total of the retained earnings column in the horizontal statements model.**

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PROBLEM 2-23A

a.

Sentry Inc. Accounting Equation for Year 1															
	Assets			=	Liabilities					+	Stockholders' Equity				
Event	Cash	+	Accts. Rec.	=	Accts Pay.	+	Notes Pay.	+	Int. Pay.	+	Com. Stock	+	Retained Earnings	Acct. Title/RE
Beg.	$0	+	$0	=	$0	+	NA	+	NA	+	$0	+	$0	
1. Issued stk.	20,000	+	NA	=	NA	+	NA	+	NA	+	20,000	+	NA	
2. Rev. on acct.	NA	+	62,000	=	NA	+	NA	+	NA	+	NA	+	62,000	Rev.
3. Loan	12,000	+	NA	=	NA	+	12,000	+	NA	+	NA	+	NA	
4. Exp. On acct.	NA	+	NA	=	3,700	+	NA	+	NA	+	NA	+	(3,700)	Exp.
5. AR collect.	5,000	+	(5,000)	=	NA	+	NA	+	NA	+	NA	+	NA	
6. AP payment	(2,900)	+	NA	=	(2,900)	+	NA	+	NA	+	NA	+	NA	
7. Interest exp.*	NA	+	NA	=	NA	+	NA	+	240	+	NA	+	(240)	Int. exp.
Totals	34,100	+	57,000	=	800	+	12,000	+	240	+	20,000	+	58,060	

*240 = (12,000 x .08) x 3/12

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PROBLEM 2-23A a. (cont.)

Sentry Inc. **Accounting Equation for Year 2**															
	Assets			=	Liabilities					+	Stockholders' Equity				
Event	Cash	+	Accts. Rec.	=	Accts Pay.	+	Notes Pay.	+	Int. Pay.	+	Com. Stock	+	Retained Earnings	Acct. Title/RE	
Beg.	$34,100	+	57,000	=	$800	+	12,000	+	240	+	20,000	+	58,060		
1. AR collect.	57,000	+	(57,000)	=	NA	+	NA	+	NA	+	NA	+	NA		
2. AP payment	(800)	+	NA	=	(800)	+	NA	+	NA	+	NA	+	NA		
3. Int. exp.*	NA	+	NA	=	NA	+	NA	+	720	+	NA	+	(720)	Int. exp.	
4. Int. pay.**	(960)	+	NA	=	NA	+	NA	+	(960)	+	NA	+	NA		
5. Note pay.	(12,000)	+	NA	=	NA	+	(12,000)	+	NA	+	NA	+	NA		
Totals	77,340	+	0	=	0	+	0	+	0	+	20,000	+	57,340		

*720 = (12,000 *.08) x 9/12

**960 = 240 + 720

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PROBLEM 2-23A (cont.)

b.

Sentry Inc.
Income Statement
For the Period Ended December 31, Year 1 & Year2

	Year 1	Year 2
Revenue	$62,000	$0
Expenses	(3,940)	(720)
Net Income	$58,060	$(720)

Sentry Inc.
Statement of Changes in Stockholders' Equity
For the Period Ended December 31, Year 1 & Year2

	Year 1	Year 2
Beginning Common Stock	$ -0-	$20,000
Plus: Common Stock Issued	20,000	0
Ending Common Stock	$20,000	$20,000
Beginning Retained Earnings	$ -0-	$58,060
Plus: Net Income	58,060	(720)
Ending Retained Earnings	$58,060	$57,340
Total Stockholders' Equity	$78,060	$77,340

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PROBLEM 2-23A b. (cont.)

Sentry Inc. Balance Sheet December 31, Year 1 & Year 2		
	Year 1	Year 2
Assets		
Cash	$34,100	$77,340
Accounts Receivable	$57,000	$0
Total Assets	$91,100	$77,340
Liabilities		
Accounts Payable	$800	$0
Interest Payable	240	0
Notes Payable	12,000	0
Total Liabilities	$13,040	$0
Stockholders' Equity		
Common Stock	$20,000	$20,000
Retained Earnings	$58,060	$57,340
Total Stockholders' Equity	$78,060	$77,340
Total Liabilities and Stockholders' Equity	$91,100	$77,340

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PROBLEM 2-23A b. (cont.)

Sentry Inc. Statement of Cash Flows For the Year Ended December 31, Year 1 & Year 2		
	Year 1	Year 2
Cash Flows From Operating Activities:		
Cash Receipts from Customers	$5,000	$57,000
Cash Payments for Expenses	(2,900)	(1,760)*
Net Cash Flow from Operating Activities	$2,100	$55,240
Cash Flows From Investing Activities		
Cash Payment for Loan	$0	$(12,000)
Net Cash Flow from Investing Activities	$0	$(12,000)
Cash Flows From Financing Activities:		
Cash Receipts from Borrowed Funds	$12,000	$0
Cash Receipts from Stock Issue	20,000	0
Net Cash Flow from Financing Activities	$32,000	$0
Net Increase in Cash	$34,100	$43,240
Plus: Beginning Cash Balance	-0-	$34,100
Ending Cash Balance	$34,100	$77,340

*$1,760 = $800 + $960

c. Sentry Inc. has $77,340 worth of assets to distribute in the event of liquidation at the end of Year 2. During liquidation, creditors have first rights to the assets and any remaining assets are distributed to owners. As the company has no debts, creditors would receive $0 and total amount of assets of $77,340 would be distributed to owners.

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PROBLEM 2-24A

a.

Bennett Company Income Statement For the Year Ended December 31, Year 1		
Revenue		
Service Revenue	$42,000	
Total Revenue		$42,000
Expenses		
Other Operating Expenses	$20,000	
Salary Expense	10,000	
Interest Expense	4,000	
Total Expenses		(34,000)
Net Income		$8,000

Bennett Company Statement of Changes in Stockholders' Equity For the Year Ended December 31, Year 1		
Beginning Common Stock	$40,000	
Plus: Stock Issued	5,000	
Ending Common Stock		$45,000
Beginning Retained Earnings	$ 15,000	
Plus: Net Income	8,000	
Less: Dividends	(3,000)	
Ending Retained Earnings		20,000
Total Stockholders' Equity		$65,000

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PROBLEM 2-24A a. (cont.)

Bennett Company Balance Sheet As of December 31, Year 1		
Assets		
Cash	$23,000	
Accounts Receivable	18,000	
Land	59,000	
Total Assets		$100,000
Liabilities		
Accounts Payable	$17,000	
Interest Payable	3,000	
Accrued Salaries Payable	5,000	
Notes Payable	10,000	
Total Liabilities		$ 35,000
Stockholders' Equity		
Common Stock	$45,000	
Retained Earnings	20,000	
Total Stockholders' Equity		$ 65,000
Total Liab. and Stockholders' Equity		$100,000

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PROBLEM 2-24A a. (cont.)

Bennett Company Statement of Cash Flows For the Year Ended December 31, Year 1	
Cash Flow From Operating Activities	$33,000
Cash Flow From Investing Activities	(32,000)
Cash Flow From Financing Activities	2,000
Net Change in Cash	3,000
Plus: Beginning Cash Balance	20,000
Ending Cash Balance	$23,000

b.

Bennett Company Accounts Receivable Summary		
Beginning AR Balance	$41,000	(X)
Increase in AR from Sales	42,000	
Reduction in AR from Collections	(65,000)	
Endings Accounts Receivable Balance	$18,000	

c.

Bennet Company Accounts Payable Summary		
Beginning accounts payable balance	$15,000	(X)
Plus: Expenses incurred on account	20,000	
Minus: Payment of accounts payable	(18,000)	
Ending accounts payable balance	$17,000	

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PROBLEM 2-25A

a.

Computation of Net Income	
Revenue recognized on account	$68,000
Less accrued salary expense	(46,000)
Net Income	$22,000

b.

Computation of Cash Collected from Accounts Receivable	
Beginning balance of Accounts Receivable	$ 4,000
Add revenue recognized on account	68,000
Less ending balance of Accounts Receivable	(4,500)
Cash collected from accounts receivable	$67,500

Computation of Cash Paid for Salaries Expense	
Beginning balance of Salaries Payable	$ 2,600
Add accrued salary expense recognized	46,000
Less ending balance of Salaries Payable	(1,500)
Cash paid for Salary Expense	$47,100

Cash Flow from Operating Activities	
Cash from Accounts Receivable	$67,500
Cash paid for Salary Expense	(47,100)
Net Cash Flow from Operating Act.	$20,400

c. Net income is the difference between services performed and expenses incurred, regardless of the cash collected or paid. Cash flow from operating activities is the difference between cash collected and paid for operating activities. The time gap between these two activities often causes a difference between the net income and cash flow from operating activities.

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PROBLEM 2-26A

The three common features of ethical misconduct are:

1. The availability of an opportunity
2. The existence of some sort of pressure
3. The capacity for rationalization

1. Even though Pete has exceeded his authority, no one has complained because he is bringing in more revenue. Oversight by a partner would eliminate this type of problem.

2. Pete is in a financial bind and does not want to discuss his problem with others for fear of ruining his image. Therefore, he is willing to take risks to keep his secret.

3. He rationalizes that his actions do not hurt anyone because the client is getting the service and the firm is getting a reasonable fee.

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SOLUTIONS TO EXERCISES – SERIES B - CHAPTER 2

EXERCISE 2-1B

a.

The Bruce Spruce Co.
Horizontal Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	Cash Flows
Event	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings						
1	75,000	+	NA	=	NA	+	75,000	+	NA	NA	–	NA	=	NA	75,000 FA
2	48,000	+	NA	=	NA	+	NA	+	48,000	48,000	–	NA	=	48,000	48,000 OA
3	(34,000)	+	NA	=	NA	+	NA	+	(34,000)	NA	–	34,000	=	(34,000)	(34,000) OA
4	20,000	+	NA	=	20,000	+	NA	+	NA	NA	–	NA	=	NA	20,000 FA
5	(38,000)	+	38,000	=	NA	+	NA	+	NA	NA	–	NA	=	NA	(38,000) IA
6	(2,000)	+	NA	=	NA	+	NA	+	(2,000)	NA	–	NA	=	NA	(2,000) FA
	69,000	+	38,000	=	20,000	+	75,000	+	12,000	48,000	–	34,000	=	14,000	69,000 NC

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EXERCISE 2-1B (cont.)

b.

The Bruce Spruce Co. Income Statement For the Period Ended December 31, Year 1	
Revenue	$48,000
Expenses	(34,000)
Net Income	$14,000

The Bruce Spruce Co. Statement of Changes in Stockholders' Equity For the Period Ended December 31, Year 1		
Beginning Common Stock	$ -0-	
Plus: Common Stock Issued	75,000	
Ending Common Stock		$75,000
Beginning Retained Earnings	$-0-	
Plus: Net Income	14,000	
Less: Dividends	(2,000)	
Ending Retained Earnings		12,000
Total Stockholders' Equity		$87,000

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EXERCISE 2-1B b. (cont.)

The Bruce Spruce Co. Balance Sheet As of December 31, Year 1		
Assets		
Cash	$69,000	
Land	38,000	
Total Assets		$107,000
Liabilities		
Notes Payable		$20,000
Stockholders' Equity		
Common Stock	$75,000	
Retained Earnings	12,000	
Total Stockholders' Equity		$87,000
Total Liabilities and Stockholders' Equity		$107,000

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EXERCISE 2-1B b. (cont.)

The Bruce Spruce Co. Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flows From Operating Activities:		
Cash Receipts from Customers	$48,000	
Cash Payments for Expenses	(34,000)	
Net Cash Flow from Operating Activities		$14,000
Cash Flows From Investing Activities:		
Cash Payment for Land	$(38,000)	
Net Cash Flow from Investing Activities		$(38,000)
Cash Flows From Financing Activities:		
Cash Receipts from Stock Issue	$75,000	
Cash Receipts from Borrowed Funds	20,000	
Cash Dividends	(2,000)	
Net Cash Flow from Financing Activities		$93,000
Net Increase in Cash		69,000
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$69,000

EXERCISE 2-2B

a.

1.	Asset source
2.	Asset source
3.	Asset source
4.	Asset exchange
5.	Asset use
6.	Asset use
7.	NA

b.

Pet Partners
Horizontal Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
Event	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings						
1	I	+	NA	=	NA	+	I	+	NA	NA	–	NA	=	NA	I FA
2	I	+	NA	=	I	+	NA	+	NA	NA	–	NA	=	NA	I FA
3	NA	+	NA	=	NA	+	NA	+	NA	NA	–	NA	=	NA	NA
4	D	+	I	=	NA	+	NA	+	NA	NA	–	NA	=	NA	D IA
5	D	+	NA	=	NA	+	NA	+	D	NA	–	I	=	D	D OA
6	D	+	NA	=	NA	+	NA	+	D	NA	–	NA	=	NA	D FA
7	NA	+	NA	=	NA	+	NA	+	NA	NA	–	NA	=	NA	NA

EXERCISE 2-3B

a. Missing items are determined as follow:

(a) $500,000; Since the cash flow column shows that this event was financing activity, we can infer that the company either borrowed money or issued stock. Since the model shows that liabilities were not affected, we conclude that the common stock account increased by $500,000.

(b) NA; Since issuing common stock (see answer to (a) above), does not affect the revenue account, the answer is not affected (NA).

(c) NA; Since issuing common stock (see answer to (a) above), does not affect net income, the answer is not affected (NA).

(d) NA; Since assets and liabilities increased, we infer that the company borrowed money. Borrowing money does not affect net income.

(e) FA; Since assets and liabilities increased, we infer that the company borrowed money. Borrowing money is a financing activity (FA).

(f) 475,000; Since cash decreased and no other balance sheet account other than the land account was affected, the company must have purchased land which would cause the land account to increase by 475,000.

(g) IA; Purchasing land (see answer to (f) above) is in investing activity (IA).

(h) 105,000; The income statement shows $105,000 of revenue. Recognizing revenue increases the cash and retained earning accounts on the balance sheet.

(i) 105,000; The income statement shows $105,000 of revenue. Recognizing revenue increases the cash and retained earning accounts on the balance sheet.

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EXERCISE 2-3B a. (cont).

(j) (80,000); The statement of cash flows shows that the $80,000 cash outflow was an operating activity. Therefore, we conclude that this is an expense item that will act to reduce the amount of retained earnings shown in the balance sheet.

(k) 80,000; The statement of cash flows shows that the $80,000 cash outflow was an operating activity. Therefore, we conclude that this is an expense item that will act to increase amount of expenses shown in the income statement.

(l) FA; Since the event decreases cash and retained earnings on the balance sheet; and does not affect the income statement, we conclude that this was a dividend payment which is a financing activity (FA).

(m) 435,000; This amount is determined by totaling the vertical column.

(n) 105,000; This amount is determined by totaling the vertical column.

EXERCISE 2-3B a. (cont.)

Completed Horizontal Statements Model

Surf's Up Industries
Horizontal Statements Model for Year 1

	Balance Sheet										Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity				Revenue	–	Expense	=	Net Inc.	
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings							
Beg.	0	+	0	=	0	+	0	+	0		0	–	0	=	0	NA
1	500,000	+	NA	=	NA	+	500,000	+	NA		NA	–	NA	=	NA	500,000 FA
2	400,000	+	NA	=	400,000	+	NA	+	NA		NA	–	NA	=	NA	400,000 FA
3	(475,000)	+	475,000	=	NA	+	NA	+	NA		NA	–	NA	=	NA	(475,000) IA
4	105,000	+	NA	=	NA	+	NA	+	105,000		105,000	–	NA	=	105,000	105,000 OA
5	(80,000)	+	NA	=	NA	+	NA	+	(80,000)		NA	–	80,000	=	(80,000)	(80,000) OA
6	(15,000)	+	NA	=	NA	+	NA	+	(15,000)		NA	–	NA	=	NA	(15,000) FA
	435,000	+	475,000	=	400,000	+	500,000	+	10,000		105,000	–	80,000	=	25,000	435,000 NC

b. $910,000 Total Assets (Cash $435,000 + Land $475,000)

c. $25,000 Net Income (Revenue $105,000 – Expenses $80,000)

d. $(475,000) Net Cash Flow from Investing Activities

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EXERCISE 2-4B

Smith Company Effect of Events on the Year 1 Financial Statements										
	Assets			=	Liabilities	+	Stockholders' Equity			
Event	Cash	+	Accounts Rec.	=		+	Common Stock	+	Retained Earnings
Earned Revenue	NA	+	12,000	=	NA	+	NA	+	12,000
Coll. Acct. Rec.	9,800	+	(9,800)	=	NA	+	NA	+	NA
Ending Balance	9,800	+	2,200	=	-0-	+	-0-	+	12,000

a. Accounts Receivable: $12,000 – $9,800 = $2,200

b. $12,000

c. $9,800 cash collected from accounts receivable.

d. $12,000

e. $12,000 of revenue was earned but only $9,800 of it was collected.

EXERCISE 2-5B

The Woodstock Shop Horizontal Statements Model for Year 1																
	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
Event	Cash	+	Accts. Rec	=	Notes Payable	+	Common Stock	+	Retained Earnings						
1	38,000	+	NA	=	NA	+	38,000	+	NA	NA	–	NA	=	NA	38,000 FA
2	NA	+	30,000	=	NA	+	NA	+	30,000	30,000	–	NA	=	30,000	NA
3	(25,000)	+	NA	=	NA	+	NA	+	(25,000)	NA	–	25,000	=	(25,000)	(25,000) OA
4	15,000	+	NA	=	15,000	+	NA	+	NA	NA	–	NA	=	NA	15,000 FA
5	25,000	+	(25,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	25,000 OA
6	(2,000)	+	NA	=	NA	+	NA	+	(2,000)	NA	–	NA	=	NA	(2,000) FA
	51,000	+	5,000	=	15,000	+	38,000	+	3,000	30,000	–	25,000	=	5,000	51,000 NC

b. Accounts receivable will appear as an "asset" on the December 31, Year 1 balance sheet.

c. $5,000. Total from the accounts receivable column in the horizontal statements model.

d. $5,000. Total from the net income column in the horizontal statements model.

e. $0. Net cash flow from operating activities ($25,000 - $25,000).

f. Cash flow from operating activities and net income are different in most cases, because there is a time gap between when revenue is earned and cash is collected. When a company earns revenue on account, this amount is reflected in net income but not cash flow from operating activities until the cash is collected.

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EXERCISE 2-6B

Kendall Company Horizontal Statements Model for Year 1															
	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
Event	Cash	+	Accts. Rec	=	Accts. Payable	+	Common Stock	+	Retained Earnings						
1	20,000	+	NA	=	NA	+	NA	+	20,000	20,000	–	NA	=	20,000	20,000 OA
2	NA	+	NA	=	10,000	+	NA	+	(10,000)	NA	–	(10,000)	=	(10,000)	NA
3	(5,000)	+	NA	=	(5,000)	+	NA	+	NA	NA	–	NA	=	NA	(5,000) OA
	15,000	+	0	=	5,000	+	0	+	10,000	20,000	–	(10,000)	=	10,000	15,000 NC

a. **\$5,000. Total from the accounts payable column in the horizontal statements model.**

b. **\$10,000. Total from the expenses column in the horizontal statements model.**

c. **\$15,000. Total cash flow from operating activities.**

d. **\$10,000. Total from the retained earnings column in the horizontal statements model.**

e. **Cash flow from operating activities and expenses are different in most cases, because there is a time gap between when an expense is incurred and when cash is paid for that expense. When a company incurs an expense, this amount is reflected in expenses on the income statement but will not impact the cash flow statement until the cash is paid.**

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EXERCISE 2-7B

a.

Star Corporation Accounting Equation - Year 1							
Event	Assets	=	Liabilities	+	Stockholders' Equity		
	Cash	=	Salaries Payable	+	Common Stock	+	Retained Earnings
Earned Rev.	5,000		NA		NA		5,000
Accrued Sal.	NA		3,000		NA		(3,000)
Ending Bal.	5,000	=	3,000	+	-0-	+	2,000

Star Corporation Balance Sheet As of December 31, Year 1		
Assets		
Cash	$5,000	
Total Assets		$5,000
Liabilities		
Salaries Payable	$3,000	
Total Liabilities		$3,000
Stockholders' Equity		
Retained Earnings	$2,000	
Total Stockholders' Equity		2,000
Total Liab. and Stockholders' Equity		$5,000

b.

Computation of Net Income	
Revenue	$5,000
Less: Expenses	(3,000)
Net Income	$2,000

EXERCISE 2-7B (cont.)

c.

Cash Flow from Operating Activities	
Cash from Revenue	**$5,000**
Net Cash Flow from Operating Act.	**$5,000**

d. **The salary expense is deducted from revenue in computing net income, but it has not been paid. This creates a difference of $3,000. The revenue is the same because it has been earned and collected.**

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EXERCISE 2-8B

a.

Talley, Inc.
General Ledger Accounts for the Year Ended December 31, Year 1

	Assets			Liabilities		Stockholders' Equity		
Event	Cash	Accts. Rec.	=	Salaries Pay.	+	Common Stock	Retained Earnings	Acct. Title for RE
1.	20,000					20,000		
2.		38,000					38,000	Revenue
3.	(2,500)						(2,500)	Util. Exp.
4.	21,000	(21,000)						
5.				15,000			(15,000)	Sal. Exp.
6.	(2,000)						(2,000)	Dividends
Totals	36,500	17,000	=	15,000	+	20,000	18,500	

b.

Talley, Inc.
Income Statement
For the Year Ended December 31, Year 1

Revenue		$38,000
Expenses		
Utilities Expense	$ 2,500	
Salaries Expense	15,000	
Total Expenses		(17,500)
Net Income		$20,500

EXERCISE 2-8B b. (cont.)

Talley, Inc. Statement of Changes in Stockholders' Equity For the Year Ended December 31, Year 1		
Beginning Common Stock	$ -0-	
Plus: Common Stock Issued	20,000	
Ending Common Stock		$20,000
Beginning Retained Earnings	$ -0-	
Plus: Net Income	20,500	
Less: Dividends	(2,000)	
Ending Retained Earnings		18,500
Total Stockholders' Equity		$38,500

Talley, Inc. Balance Sheet As of December 31, Year 1		
Assets		
Cash	$36,500	
Accounts Receivable	17,000	
Total Assets		$53,500
Liabilities		
Salaries Payable	$15,000	
Total Liabilities		$15,000
Stockholders' Equity		
Common Stock	$20,000	
Retained Earnings	18,500	
Total Stockholders' Equity		38,500
Total Liab. and Stockholders' Equity		$53,500

EXERCISE 2-8B b. (cont.)

Talley, Inc. Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash Flow From Operating Activities		
Cash Receipts from Customers	$21,000	
Cash Paid for Expenses	(2,500)	
Net Cash Flow from Operating Act.		$18,500
Cash Flow From Investing Activities		-0-
Cash Flow From Financing Activities		
Issue of Stock	$20,000	
Paid Dividends	(2,000)	
Net Cash Flow from Financing Act.		18,000
Net Change in Cash		36,500
Plus: Beginning Cash Balance		-0-
Ending Cash Balance		$36,500

c. Net income is based on income earned of $38,000 and expenses incurred of $17,500 for a net income of $20,500. Net cash flow from operating activities is based on cash collected from revenue, $21,000 and expenses paid, $2,500, for a net cash flow from operating activities of $18,500. The difference of $2,000 is reflected in the Accounts Receivable account ($17,000), revenues accrued but not yet collected, and the Salaries Payable account ($15,000), expenses incurred but not paid.

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EXERCISE 2-9B

a.

Parker and Moates
Statements Model
Year 1

Event	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liabilities			+	Stk. Equity	Rev.	–	Exp.	=	Net Inc.	
	Cash	+	Accts. Rec.	=	Acct. Payable	+	Sal. Pay.	+	Retained Earnings						
1.	NA	+	96,000	=	NA	+	NA	+	96,000	96,000	–	NA	=	96,000	NA
2.	65,000	+	NA	=	NA	+	NA	+	65,000	65,000	–	NA	=	65,000	65,000 OA
3.	NA	+	NA	=	45,000	+	NA	+	(45,000)	NA	–	45,000	=	(45,000)	NA
4.	(26,000)	+	NA	=	NA	+	NA	+	(26,000)	NA	–	26,000	=	(26,000)	(26,000) OA
5.	70,000	+	(70,000)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	70,000 OA
6.	(38,000)	+	NA	=	(38,000)	+	NA	+	NA	NA	–	NA	=	NA	(38,000) OA
7.	(10,000)	+	NA	=	NA	+	NA	+	(10,000)	NA	–	NA	=	NA	(10,000) FA
8.	NA	+	NA	=	NA	+	3,000	+	(3,000)	NA	–	3,000	=	(3,000)	NA
Totals	61,000	+	26,000	=	7,000	+	3,000	+	77,000	161,000	–	74,000	=	87,000	61,000 NC

b. Total assets: $87,000 ($61,000 + $26,000)
c. $26,000
d. $7,000
e. Accounts Receivable (an asset) is an amount owed to Parker and Moates: $26,000; Accounts Payable (a liability) is an amount that Parker and Moates owes: $7,000.
f. $87,000
g. $71,000 ($65,000 – $26,000 + $70,000 – $38,000)

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EXERCISE 2-10B

a. & c.

Event	Revenue	Expense	Statement of Cash Flows
1.	NA	NA	$50,000 FA
2.	$67,000	NA	NA
3.	NA	NA	(5,000) FA
4.	NA	NA	45,000 OA
5.	NA	$49,000	(49,000) OA
6.	10,000	NA	10,000 OA
7.	NA	2,000	NA

b.

Computation of Net Income	
Revenue	$77,000
Less: Expenses	(51,000)
Net Income	$26,000

d.

Cash Flow from Operating Activities	
Cash from Revenue	$55,000
Cash paid for expenses	(49,000)
Net Cash Flow from Operating Act.	$ 6,000

e. The balance of Retained Earnings on the Year 1 Balance Sheet will be the amount of Net Income: $26,000, less $5,000 of dividends paid since there is no beginning balance in Retained Earnings.

EXERCISE 2-11B

Hall, Inc. Effect of Events on the General Ledger Accounts									
	Assets			=	Liabilities	+	Stockholders' Equity		
Event	Cash	Accounts Receivable	Land	=	Accounts Payable	+	Com. Stock	+	Retained Earnings
1. Sales on Account		62,000							62,000
2. Coll. Accts. Rec.	51,000	(51,000)							
3. Incurred Expense					39,000				(39,000)
4. Pd. Acc. Pay.	(31,000)				(31,000)				
5. Issue of Stock	40,000						40,000		
6. Purchase Land	(21,000)		21,000						
Totals	39,000	11,000	21,000	=	8,000	+	40,000	+	23,000

a. Revenue recognized, $62,000.

b. Cash flow from revenue, $51,000.

c. Revenue, $62,000, less operating expenses, $39,000 = $23,000 net income.

d. Accounts receivable collected, $51,000, less cash paid for expenses, $31,000 = $20,000 cash flow from operating activities.

e. Income of $62,000 was earned, but only $51,000 was collected (a difference of $11,000); operating expenses incurred were $39,000 but only $31,000 was paid during the period (a difference of $8,000). Consequently, net income is $3,000 more than cash flow from operating activities.

f. $21,000 cash outflow for the purchase of land.

g. $40,000 cash inflow from the issue of common stock.

h. Total assets = $71,000 ($39,000 + $11,000 + $21,000)
Total liabilities = $8,000
Total equity = $63,000 ($40,000 + $23,000)

EXERCISE 2-12B

a. Directly matched

b. Period expense

c. Period expense

d. Directly matched

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EXERCISE 2-13B

a. $10,000 x 9% = $900; $900 x 4/12 = $300

b. $300

c. $-0-, No interest was paid in Year 1; $900 of interest will be paid in Year 2 when the note matures.

d.

Connelly Company
Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
Event	Assets	=	Liabilities			+	Stockholders' Equity			Rev.	−	Exp.	=	Net Inc.	
No.	Cash	=	Notes Payable	+	Int. Payable	+	Common Stock	+	Ret. Earn.						
1.	I		NA		NA		NA		I	I		NA		I	I OA
2.	I		I		NA		NA		NA	NA		NA		NA	I FA
3.	NA		NA		I		NA		D	NA		I		D	NA

EXERCISE 2-14B

a. Interest expense recognized for Year 1: $120,000 x 7% = $8,400; $8,400 x 5/12 = $3,500

b.

California Company Accounting Equation for Year 1									
	Assets	=	Liabilities			+	Equity		
Event	Cash		Note Payable	+	Interest Payable		Common Stock	+	Retained Earnings
Note	120,000	=	120,000	+	NA	+	NA		NA
Adj.	NA		NA		3,500		NA		(3,500)

See the adjusting entry in the accounting equation above (liabilities increase, equity decreases).

c. $-0-. All interest will be paid at maturity, August 1, Year 2, for this note payable.

d. $3,500

e. $8,400 ($120,000 x 7%). All interest will be paid when the note payable matures.

f. $4,900 ($120,000 x 7% x 7/12)

g. $-0-

EXERCISE 2-15B

Solve for "X" in the following scenarios:

a.

W Co. Accounts Receivable Summary		
Beginning AR Balance	$5,000	
Increase in AR from Sales	72,500	
Reduction in AR from Collections	(70,000)	
Endings Accounts Receivable Balance	$7,500	(X)

b.

W Co. Accounts Receivable Summary		
Beginning AR Balance	$3,800	(X)
Increase in AR from Sales	60,600	
Reduction in AR from Collections	(61,200)	
Endings Accounts Receivable Balance	$3,200	

c.

W Co. Accounts Receivable Summary		
Beginning AR Balance	$11,300	
Increase in AR from Sales	102,400	
Reduction in AR from Collections	(97,900)	(X)
Endings Accounts Receivable Balance	$15,800	

EXERCISE 2-15B a. (cont.)

d.

W Co. Accounts Receivable Summary		
Beginning AR Balance	$18,000	
Increase in AR from Sales	135,500	(X)
Reduction in AR from Collections	(125,000)	
Endings Accounts Receivable Balance	$28,500	

EXERCISE 2-16B

Solve for "X" in the following scenarios:

a.

W Co. Accounts Payable Summary		
Beginning accounts payable balance	$5,500	
Plus: Expenses incurred on account	45,200	
Minus: Payment of accounts payable	(43,100)	
Ending accounts payable balance	$7,600	(X)

b.

W Co. Accounts Payable Summary		
Beginning accounts payable balance	$4,700	(X)
Plus: Expenses incurred on account	55,200	
Minus: Payment of accounts payable	(54,600)	
Ending accounts payable balance	$5,300	

c.

W Co. Accounts Payable Summary		
Beginning accounts payable balance	$3,000	
Plus: Expenses incurred on account	73,000	
Minus: Payment of accounts payable	(67,500)	(X)
Ending accounts payable balance	$8,500	

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EXERCISE 2-16B a. (cont.)

d.

W Co. Accounts Payable Summary		
Beginning accounts payable balance	$6,750	
Plus: Expenses incurred on account	86,050	(X)
Minus: Payment of accounts payable	(82,000)	
Ending accounts payable balance	$10,800	

EXERCISE 2-17B

a. Solve for "X"

London Falls Inc. Accounts Receivable Summary		
Beginning AR Balance	$15,000	
Increase in AR from Sales	58,500	(X)
Reduction in AR from Collections	(65,000)	
Endings Accounts Receivable Balance	$8,500	

b. $5,500. Revenue ($58,500) minus expenses ($53,000).

c. $12,000. Cash inflow from AR collections ($65,000) minus cash expenses ($53,000).

d. Cash flow from operating activities and net income are different in most cases, because there is a time gap between when revenue is earned and cash is collected. When a company earns revenue on account, this amount is reflected in net income but will not be reflected on the cash flow statement until the cash is collected.

EXERCISE 2-18B

a. Solve for "X"

Shelby Enterprises Accounts Payable Summary		
Beginning accounts payable balance	$25,000	
Plus: Expenses incurred on account	78,000	(X)
Minus: Payment of accounts payable	(85,000)	
Ending accounts payable balance	$18,000	

b. $37,000. Revenue ($115,000) minus expenses ($78,000).

c. $30,000. Cash inflow from sales ($115,000) minus cash outflow for expenses ($85,000).

d. Cash flow from operating activities and expenses are different in most cases, because there is a time gap between when an expense is incurred and when cash is paid for that expense. When a company incurs an expense, this amount is reflected in expenses on the income statement but will not impact the cash flow statement until the cash is paid.

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EXERCISE 2-19B

One provision of the Sarbanes-Oxley Act of 2002 clarifies the legal responsibility of company management, including the CFO and controller. This provision states that the company chief executive officer (CEO) and the chief financial officer (CFO) must certify in writing that they have reviewed the financial reports being issued, and that the reports present fairly the company's financial status. This provision would apply to the CEO and CFO of Hewlett-Packard Company. CEOs and CFOs who make intentional misrepresentations are subject to a fine of up to $5 million and imprisonment of up to 20 years.

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SOLUTIONS TO PROBLEMS – SERIES B – CHAPTER 2
PROBLEM 2-20B

a.

Daley Company
Horizontal Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
Event No.	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings						
1	52,000	+	NA	=	NA	+	52,000	+	NA	NA	–	NA	=	NA	52,000 FA
2	20,000	+	NA	=	20,000	+	NA	+	NA	NA	–	NA	=	NA	20,000 FA
3	42,000	+	NA	=	NA	+	NA	+	42,000	42,000	–	NA	=	42,000	42,000 OA
4	(23,000)	+	NA	=	NA	+	NA	+	(23,000)	NA	–	23,000	=	(23,000)	(23,000) OA
5	(6,000)	+	NA	=	NA	+	NA	+	(6,000)	NA	–	NA	=	NA	(6,000) FA
6	10,000	+	NA	=	NA	+	10,000	+	NA	NA	–	NA	=	NA	10,000 FA
7	(10,000)	+	NA	=	(10,000)	+	NA	+	NA	NA	–	NA	=	NA	(10,000) FA
8	(45,000)	+	45,000	=	NA	+	NA	+	NA	NA	–	NA	=	NA	(45,000) IA
9	NA	+	NA	=	NA	+	NA	+	NA	NA	–	NA	=	NA	NA
Total	40,000	+	45,000	=	10,000	+	62,000	+	13,000	42,000	–	23,000	=	19,000	40,000 NC

b. Total Assets = $40,000 + $45,000 = $85,000

c.

Sources of Assets	
Event	
1. Issue of stock	$ 52,000
2. Cash from loan	20,000
3. Cash from revenue	42,000
6. Issue of stock	10,000
Total Sources of Assets	$124,000

PROBLEM 2-20B (cont.)

d. Net income is $19,000 (see part a.) Dividends are not expenses so they do not appear on the income statement.

e.

Operating Activities:	
Cash from customers	$42,000
Cash paid for expenses	(23,000)
Net Cash Flow from Operating Activities	$19,000

Investing Activities:	
Cash paid to purchase land	$(45,000)
Net Cash Flow from Investing Activities	$(45,000)

Financing Activities:	
Cash from stock issues ($52,000 + $10,000)	$62,000
Cash from loan	20,000
Paid cash dividend	(6,000)
Cash paid on loan principal	(10,000)
Net Cash Flow from Financing Activities	$66,000

f. Percentage of assets provided by:

Creditors	$10,000 ÷ $85,000 = 11.76%
Investors	$62,000 ÷ $85,000 = 72.94%
Earnings	$13,000 ÷ $85,000 = 15.29%

g. Zero. The revenue is recorded in a Revenue account not in the Retained Earnings account. The balance in the Revenue account is transferred to Retained Earnings at the end of the accounting period through the closing process.

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PROBLEM 2-21B

Event No.	Description
4	Earned cash revenue.
3	Incurred expenses on account.
6	Incurred cash expenses.
7	Used cash to pay off accounts payable.
5	Collected cash from customer accounts receivable.
8	Paid a cash dividend.
1	Issued common stock for cash.
2	Earned revenue on account.

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PROBLEM 2-22B

Waddell Company Statements Model for Year 2															
	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets					=	Liab.	+	S. Equity		Rev.	–	Exp.	=	Net Inc.	
Date	Cash	+	Accts. Rec.	+	Land	=	Accts. Pay.	+	Common Stock	Retained Earn.						
Beg.	52,000	+	23,000	+	45,000	=	12,500	+	35,000	72,500	NA	–	NA	=	NA	52,000
1/1	35,000	+	NA	+	NA	=	NA	+	35,000	NA	NA	–	NA	=	NA	35,000 FA
3/1	(4,000)	+	NA	+	NA	=	NA	+	NA	(4,000)	NA	–	NA	=	NA	(4,000) FA
4/1	(20,000)	+	NA	+	20,000	=	NA	+	NA	NA	NA	–	NA	=	NA	(20,000) IA
5/1	(7,000)	+	NA	+	NA	=	(7,000)	+	NA	NA	NA	–	NA	=	NA	(7,000) OA
9/1	25,000	+	NA	+	(25,000)	=	NA	+	NA	NA	NA	–	NA	=	NA	25,000 IA
12/31	NA	+	65,000	+	NA	=	NA	+	NA	65,000	65,000	–	NA	=	65,000	NA
12/31	55,000	+	(55,000)	+	NA	=	NA	+	NA	NA	NA	–	NA	=	NA	55,000 OA
12/31	NA	+	NA	+	NA	=	34,000	+	NA	(34,000)	NA	–	34,000	=	(34,000)	NA
12/31	NA	+	NA	+	NA	=	NA	+	NA	NA	NA	–	NA	=	NA	NA
Totals	136,000	+	33,000	+	40,000	=	39,500	+	70,000	99,500	65,000	–	34,000	=	31,000	136,000 NC

a. $40,000. Total of the land column in the horizontal statements model.

b. $48,000. Cash inflows of $55,000 minus cash outflows of $7,000.

c. $39,500. Total of the liabilities column in the horizontal statements model.

d. $5,000. Cash inflow from the sale of land ($25,000) minus cash outflow from the purchase of land ($20,000).

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PROBLEM 2-22B (cont.)

e. $34,000. Total of the expenses column in the horizontal statements model.

f. $65,000. Total of the revenue column in the horizontal statements model.

g. $31,000. Cash inflow from issuance of common stock ($35,000) minus cash outflow from dividend ($4,000).

h. $31,000. Revenues ($65,000) minus expenses ($34,000).

i. $99,500. Total of the retained earnings column in the horizontal statements model.

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PROBLEM 2-23B

a.

Matchstix
Accounting Equation for Year 1

	Assets			=	Liabilities					+	Stockholders' Equity			
Event	Cash	+	Accts. Rec.	=	Accts Pay.	+	Notes Pay.	+	Int. Pay.	+	Com. Stock	+	Retained Earnings	Acct. Title/RE
Beg.	$0	+	$0	=	$0	+	NA	+	NA	+	$0	+	$0	
1. Issued stk.	50,000	+	NA	=	NA	+	NA	+	NA	+	50,000	+	NA	
2. Rev. on acct.	NA	+	24,000	=	NA	+	NA	+	NA	+	NA	+	24,000	Rev.
3. Loan	22,000	+	NA	=	NA	+	22,000	+	NA	+	NA	+	NA	
4. Exp. On acct.	NA	+	NA	=	10,500	+	NA	+	NA	+	NA	+	(10,500)	Exp.
5. AR collect.	7,000	+	(7,000)	=	NA	+	NA	+	NA	+	NA	+	NA	
6. AP payment	(3,500)	+	NA	=	(3,500)	+	NA	+	NA	+	NA	+	NA	
7. Interest exp.*	NA	+	NA	=	NA	+	NA	+	330	+	NA	+	(330)	Int. exp.
Totals	75,500	+	17,000	=	7,000	+	22,000	+	330	+	50,000	+	13,170	

*330 = (22,000 x .06) x 3/12

PROBLEM 2-23B a. (cont.)

Matchstix Accounting Equation for Year 2																
	Assets			=	Liabilities					+	Stockholders' Equity			
Event	Cash	+	Accts. Rec.	=	Accts Pay.	+	Notes Pay.	+	Int. Pay.	+	Com. Stock	+	Retained Earnings	Acct. Title/RE
Beg.	$75,500	+	17,000	=	7,000	+	22,000	+	330	+	50,000	+	13,170	
1. AR collect.	17,000	+	(17,000)	=	NA	+	NA	+	NA	+	NA	+	NA	
2. AP payment	(7,000)	+	NA	=	(7,000)	+	NA	+	NA	+	NA	+	NA	
3. Int. exp.*	NA	+	NA	=	NA	+	NA	+	990	+	NA	+	(990)	Int. exp.
4. Int. pay.**	(1,320)	+	NA	=	NA	+	NA	+	(1,320)	+	NA	+	NA	
5. Note pay.	(22,000)	+	NA	=	NA	+	(22,000)	+	NA	+	NA	+	NA	
Totals	62,180	+	0	=	0	+	0	+	0	+	50,000	+	12,180	

*990 = (22,000 *.06) x 9/12
**1,320 = 330 + 990

PROBLEM 2-23B (cont.)

b.

Matchstix Income Statement For the Period Ended December 31, Year 1 & Year2		
	Year 1	Year 2
Revenue	$24,000	$0
Expenses	(10,830)	(990)
Net Income	$13,170	$(990)

Matchstix Statement of Changes in Stockholders' Equity For the Period Ended December 31, Year 1 & Year2		
	Year 1	Year 2
Beginning Common Stock	$ -0-	$50,000
Plus: Common Stock Issued	50,000	0
Ending Common Stock	$50,000	$50,000
Beginning Retained Earnings	$ -0-	$13,170
Plus: Net Income	13,170	(990)
Ending Retained Earnings	$13,170	$12,180
Total Stockholders' Equity	$63,170	$62,180

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PROBLEM 2-23B b. (cont.)

Matchstix Balance Sheet December 31, Year 1 & Year 2		
	Year 1	Year 2
Assets		
Cash	$75,500	$62,180
Accounts Receivable	$17,000	$0
Total Assets	$92,500	$62,180
Liabilities		
Accounts Payable	$7,000	$0
Interest Payable	330	0
Notes Payable	22,000	0
Total Liabilities	$29,330	$0
Stockholders' Equity		
Common Stock	$50,000	$50,000
Retained Earnings	$13,170	$12,180
Total Stockholders' Equity	$63,170	$62,180
Total Liabilities and Stockholders' Equity	$92,500	$62,180

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PROBLEM 2-23B b. (cont.)

Matchstix Statement of Cash Flows For the Year Ended December 31, Year 1 & Year 2		
	Year 1	Year 2
Cash Flows From Operating Activities:		
Cash Receipts from Customers	$7,000	$17,000
Cash Payments for Expenses	(3,500)	(8,320)*
Net Cash Flow from Operating Activities	$3,500	$8,680
Cash Flows From Investing Activities		
Cash Payment for Loan	$0	$(22,000)
Net Cash Flow from Investing Activities	$0	$(22,000)
Cash Flows From Financing Activities:		
Cash Receipts from Borrowed Funds	$22,000	$0
Cash Receipts from Stock Issue	50,000	0
Net Cash Flow from Financing Activities	$72,000	$0
Net Increase in Cash	$75,500	$(13,320)
Plus: Beginning Cash Balance	-0-	75,500
Ending Cash Balance	$75,500	$62,180

*$8,320 = $7,000 + $1,320

c. Matchstix has $62,180 worth of assets to distribute in the event of liquidation at the end of Year 2. During liquidation, creditors have first rights to the assets and any remaining assets are distributed to owners. As the company has no debts, creditors would receive $0 and total amount of assets of $62,180 would be distributed to owners.

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PROBLEM 2-24B

a.

Tristan Company Income Statement For the Year Ended December 31, Year 1		
Revenue		
Service Revenue	$65,000	
Total Revenue		$65,000
Expenses		
Other Operating Expenses	$18,000	
Salary Expense	12,000	
Interest Expense	5,000	
Total Expenses		(35,000)
Net Income		$30,000

Tristan Company Statement of Changes in Stockholders' Equity For the Year Ended December 31, Year 1		
Beginning Common Stock	$55,000	
Plus: Stock Issued	10,000	
Ending Common Stock		$65,000
Beginning Retained Earnings	$ 10,000	
Plus: Net Income	30,000	
Less: Dividends	(2,000)	
Ending Retained Earnings		38,000
Total Stockholders' Equity		$103,000

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PROBLEM 2-24B a. (cont.)

Tristan Company Balance Sheet As of December 31, Year 1		
Assets		
Cash	$ 35,000	
Accounts Receivable	32,000	
Land	75,000	
Total Assets		$142,000
Liabilities		
Accounts Payable	$12,000	
Interest Payable	5,000	
Accrued Salaries Payable	9,000	
Notes Payable	13,000	
Total Liabilities		$39,000
Stockholders' Equity		
Common Stock	$65,000	
Retained Earnings	38,000	
Total Stockholders' Equity		$103,000
Total Liab. and Stockholders' Equity		$142,000

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PROBLEM 2-24B a. (cont.)

Tristan Company Statement of Cash Flows For the Year Ended December 31, Year 1	
Cash Flow From Operating Activities	$45,000
Cash Flow From Investing Activities	(36,000)
Cash Flow From Financing Activities	8,000
Net Change in Cash	17,000
Plus: Beginning Cash Balance	18,000
Ending Cash Balance	$35,000

b.

Tristan Company Accounts Receivable Summary		
Beginning AR Balance	$13,000	(X)
Increase in AR from Sales	65,000	
Reduction in AR from Collections	(46,000)	
Endings Accounts Receivable Balance	$32,000	

c.

Tristan Company Accounts Payable Summary		
Beginning accounts payable balance	$17,000	(X)
Plus: Expenses incurred on account	18,000	
Minus: Payment of accounts payable	(23,000)	
Ending accounts payable balance	$12,000	

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PROBLEM 2-25B

a.

Computation of Net Income	
Revenue recognized on account	$40,000
Less accrued salary expense	(35,000)
Net Income	$ 5,000

b.

Computation of Cash Collected from Accounts Receivable	
Beginning balance of Accounts Receivable	$ 2,000
Add revenue recognized on account	40,000
Less ending balance of Accounts Receivable	(2,400)
Cash collected from accounts receivable	$39,600

Computation of Cash Paid for Salaries Expense	
Beginning balance of Salaries Payable	$ 1,300
Add accrued salary expense recognized	35,000
Less ending balance of Salaries Payable	(900)
Cash paid for salary expense	$35,400

Cash Flow from Operating Activities	
Cash from accounts receivable	$39,600
Cash paid for salary expense	(35,400)
Net Cash Flow from Operating Act.	$ 4,200

c. Net income is the difference between services performed and expenses incurred, regardless of the cash collected or paid. Cash flow from operating activities is the difference between cash collected and paid for operating activities. The time gap between these two activities often causes a difference between the net income and cash flow from operating activities.

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PROBLEM 2-26B

a.

Several of the principles should be mentioned in the memo.

<u>Responsibilities Principle</u>
As a professional, Kato should exercise professional and moral judgment in his position.

Integrity Principle
Kato should perform his duties with the highest sense of integrity.

<u>Due Care Principle</u>
Members are required be competent in their areas of responsibility and to perform professional duties to the best of his/her ability.

b. Pleading ignorance would not relieve Kato of responsibility. The due care principle requires that members of the profession be competent and provide quality services.

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EXERCISES - SERIES B - CHAPTER 2 WORKING PAPERS

Exercise 2-1B ***Recording events in a horizontal financial statements model*** **LO 2-1**

The Bruce Spruce Co. experienced the following events during its first year of operations, Year 1:

1. Acquired $75,000 cash by issuing common stock.
2. Earned $48,000 cash revenue.
3. Paid $34,000 cash for operating expenses.
4. Borrowed $20,000 cash from a bank.
5. Paid $38,000 cash to purchase land.
6. Paid a $2,000 cash dividend.

Required

a. Use a horizontal financial statements model to show how each event affects the balance sheet, income statement, and statement of cash flows. More specifically, record the amounts of the events into the model. Also, in the Statement of Cash Flows column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first transaction is shown as an example.

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stk. Equity								
Event	Cash	+	Land	=	Notes Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	
1.	75,000	+	NA	=	NA	+	75,000	+	NA	NA	−	NA	=	NA	75,000 FA

a.

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The Bruce Spruce Co.
Horizontal Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	Cash Flows
Event	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings						
1	75,000	+	NA	=	NA	+	75,000	+	NA	NA	–	NA	=	NA	75,000 FA
2															
3															
4															
5															
6															
	69,000	+	38,000	=	20,000	+	75,000	+	12,000	48,000	–	34,000	=	14,000	69,000 NC

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EXERCISE 2-1B (cont.)

b. Prepare a formal income statement, statement of changes in stockholders' equity, balance sheet, and statement of cash flows.

The Bruce Spruce Co.
Income Statement

The Bruce Spruce Co.
Statement of Changes in Stockholders' Equity

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EXERCISE 2-1B b. (cont.)

The Bruce Spruce Co.
Balance Sheet

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EXERCISE 2-1B b. (cont.)

The Bruce Spruce Co.
Statement of Cash Flows

Exercise 2-2B *Types of transactions and the horizontal financial statements model* LO 2-1

Pet Partners experienced the following events during its first year of operations, Year 1:

1. Acquired cash by issuing common stock.
2. Borrowed cash from a bank.
3. Signed a contract to provide services in the future.

.

4. Purchased land with cash.
5. Paid cash for operating expenses.
6. Paid a cash dividend to the stockholders.
7. Determined that the market value of the land is higher than the historical cost.

Required

a. Indicate whether each event is an asset source, use, or exchange transaction.

1.	
2.	
3.	
4.	
5.	
6.	
7.	

EXERCISE 2-2B (cont.)

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b. Use a horizontal financial statements model to show how each event affects the balance sheet, income statement, and statement of cash flows. Indicate whether the event increases (I), decreases (D), or does not affect (NA) each element of the financial statements. Also, in the Statement of Cash Flows column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first transaction is shown as an example.

Event	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stk. Equity								
	Cash	+	Land	=	Notes Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	
1.	I	+	NA	=	NA	+	I	+	NA	NA	−	NA	=	NA	I FA

Pet Partners
Horizontal Statements Model for Year 1

Event	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings						
1	I	+	NA	=	NA	+	I	+	NA	NA	–	NA	=	NA	I FA
2															
3															
4															
5															
6															
7															

LO 2-1

Exercise 2-3B *Calculate missing amounts and interpret results*

The following horizontal financial statements model shows the transactions experienced by Surf's Up Industries during Year 1. The table contains missing data that are labeled with alphabetic characters (a) through (n). Assume all transactions shown in the accounting equation are cash transactions.

	Balance Sheet									Income Statement					Statement of Cash Flows	
	Assets			=	Liab.	+	Stockholders' Equity									
Event	Cash	+	Land	=	Notes Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.		
Beg.	0	+	0	=	0	+	0	+	0	0	−	0	=	0	NA	
1.	500,000	+	NA	=	NA	+	(a)	+	NA	(b)	−	NA	=	(c)	500,000	FA
2.	400,000	+	NA	=	400,000	+	NA	+	NA	NA	−	NA	=	(d)	400,000	(e)
3.	(475,000)	+	(f)	=	NA	+	NA	+	NA	NA	−	NA	=	NA	(475,000)	(g)
4.	(h)	+	NA	=	NA	+	NA	+	(i)	105,000	−	NA	=	105,000	105,000	OA
5.	(80,000)	+	NA	=	NA	+	NA	+	(j)	NA	−	(k)	=	(80,000)	(80,000)	OA
6.	(15,000)	+	NA	=	NA	+	NA	+	(15,000)	NA	−	NA	=	NA	(15,000)	(l)
End	(m)	+	475,000	=	400,000	+	500,000	+	10,000	(n)	−	80,000	=	25,000	435,000	NC

Required

a. Use amounts or alphabetic letters to fill in the blanks highlighted by each character (a) through (n). Use the letters NA to indicate that no amount is related to the alpha character shown in the model. Use the letters FA to represent financing activity; IA to represent investing activities; OA to represent operating activities, and NC to represent net change.

b. Determine the total amount of assets that will appear on the December 31, Year 1, balance sheet.

c. Determine the total amount of net income that will appear on the income statement.

d. Determine the amount of cash flow from investing activities that will appear on the statement of cash flows.

EXERCISE 2-3B a. (cont.)

Surf's Up Industries
Horizontal Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings						
Beg.	0	+	0	=	0	+	0	+	0	0	–	0	=	0	NA
1	500,000	+	NA	=	NA	+	(a)	+	NA	(b)	–	NA	=	(c)	500,000 FA
2	400,000	+	NA	=	400,000	+	NA	+	NA	NA	–	NA	=	(d)	(e)
3	(475,000)	+	(f)	=	NA	+	NA	+	NA	NA	–	NA	=	NA	(g)
4	(h)	+	NA	=	NA	+	NA	+	(i)	105,000	–	NA	=	105,000	105,000 OA
5	(80,000)	+	NA	=	NA	+	NA	+	(j)	NA	–	(k)	=	(80,000)	(80,000) OA
6	(15,000)	+	NA	=	NA	+	NA	+	(15,000)	NA	–	NA	=	NA	(l)
	(m)	+	475,000	=	400,000	+	500,000	+	10,000	(n)	–	80,000	=	25,000	435,000 NC

b. **Total Assets =**

c. **Net Income =**

d. **Net Cash Flow from Investing Activities =**

Exercise 2-4B *Effect of collecting accounts receivable on the accounting equation* **LO 2-2, 2-4**

Smith Company earned $12,000 of service revenue on account during Year 1. The company collected $9,800 cash from accounts receivable during Year 1.

Required

Based on this information alone, determine the following for Smith Company. (*Hint:* Record the events in a horizontal financial statements model before satisfying the requirements.)

a. The balance of the accounts receivable that Smith would report on the December 31, Year 1, balance sheet.

b. The amount of net income that Smith would report on the Year 1 income statement.

c. The amount of net cash flow from operating activities that would be reported on the Year 1 statement of cash flows.

d. The amount of retained earnings that would be reported on the Year 1 balance sheet.

e. Why are the answers to Requirements *b* and *c* different?

Smith Company
Effect of Events on the Year 1 Financial Statements

	Assets			=	Liabilities	+	Stockholders' Equity		
Event	Cash	+	Accounts Rec.	=		+	Common Stock	+	Retained Earnings
Earned Revenue		+		=		+			
Coll. Acct. Rec.		+		=		+			
Ending Balance		+		=		+			

a. **Accounts Receivable 12/31/Year 1 =**

b. **Net income =**

c. **Net cash flows from operating activities =**

d. **Retained earnings =**

e.

Exercise 2-5B ***Recording accounts receivable and other events in a horizontal financial statements model*** **LO 2-1, 2-2, 2-4**

The Woodstock Shop experienced the following events during its first year of operations, Year 1:

1. Acquired $38,000 cash by issuing common stock.
2. Earned $30,000 revenue on account.
3. Paid $25,000 cash for operating expenses.
4. Borrowed $15,000 cash from a bank.
5. Collected $25,000 of the balance in accounts receivable.
6. Paid a $2,000 cash dividend.

Required

a. Use a horizontal financial statements model to show how each event affects the balance sheet, income statement, and statement of cash flows. More specifically, record the amounts of the events into the model. Also, in the Statement of Cash Flows column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first transaction is shown as an example.

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stk. Equity								
Event	Cash	+	Accts. Rec.	=	Notes Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	
1.	38,000	+	NA	=	NA	+	38,000	+	NA	NA	−	NA	=	NA	38,000 FA

EXERCISE 2-5B (cont.)

a.

The Woodstock Shop
Horizontal Statements Model for Year 1

Event	Balance Sheet: Assets: Cash	+	Accts. Rec	=	Liab.: Notes Payable	+	Stockholders' Equity: Common Stock	+	Retained Earnings	Income Statement: Revenue	–	Expense	=	Net Inc.	Statement of Cash Flows
1	38,000	+	NA	=	NA	+	38,000	+	NA	NA	–	NA	=	NA	38,000 FA
2															
3															
4															
5															
6															
	51,000	+	5,000	=	15,000	+	38,000	+	3,000	30,000	–	25,000	=	5,000	51,000 NC

EXERCISE 2-5B (cont.)

b. Would the accounts receivable account appear in the assets, liabilities, or stockholders' equity section of the December 31, Year 1, balance sheet?

c. Determine the balance of the accounts receivable account that would appear on the December 31, Year 1, balance sheet.

d. Determine the amount of net income that would appear in the Year 1 income statement.

e. Determine the amount of the cash flow from operating activities that would appear in the Year 1 statement of cash flows.

f. Explain why the amount determined in Requirement *d* differs from the amount determined in Requirement *e*.

b.

c.

d.

e.

f.

Exercise 2-6B ***Effect of collecting accounts payable on financial statements*** **LO 2-1, 2-3, 2-4**

Kendall Company earned $20,000 of cash revenue. Kendall Co. incurred $10,000 of utility expense on account during Year 1. The company made cash payments of $5,000 to reduce its accounts payable during Year 1.

Required

Based on this information alone, determine the following for Kendall Company. (*Hint:* Record the events in a horizontal financial statements model before satisfying the requirements.)

a. The balance of the accounts payable that would be reported on the December 31, Year 1, balance sheet.

b. The amount of expenses that would be reported on the Year 1 income statement.

c. The amount of net cash flow from operating activities that would be reported on the Year 1 statement of cash flows.

d. The amount of retained earnings that would be reported on the Year 1 balance sheet.

e. Why are the answers to Requirements *b* and *c* different?

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EXERCISE 2-6B (cont.)

Kendall Company Horizontal Statements Model for Year 1															
	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity			Revenue	–	Expense	=	Net Inc.	
Event	Cash	+	Accts. Rec	=	Accts. Payable	+	Common Stock	+	Retained Earnings						
1		+		=		+		+			–		=		
2		+		=		+		+			–		=		
3		+		=		+		+			–		=		
		+		=		+		+			–		=		

a.

b.

c.

d.

e.

LO 2-3, 2-4

Exercise 2-7B ***Effect of accrued expenses on the accounting equation and financial statements***

During Year 1, Star Corporation earned $5,000 of cash revenue and accrued $3,000 of salaries expense.

Required

(*Hint:* Record the events in general ledger accounts under an accounting equation before satisfying the requirements.) Based on this information alone:

a. Prepare the December 31, Year 1, balance sheet.

Star Corporation Accounting Equation - Year 1							
Event	Assets	=	Liabilities	+	Stockholders' Equity		
	Cash	=	Salaries Payable	+	Common Stock	+	Retained Earnings
Earned Rev.							
Accrued Sal.							
Ending Bal.							

(a)

Star Corporation Balance Sheet			

EXERCISE 2-7B (cont.)

b. Determine the amount of net income that Star would report on the Year 1 income statement.

c. Determine the amount of net cash flow from operating activities that Star would report on the Year 1 statement of cash flows.

d. Why are the answers to Requirements *b* and *c* different?

b.

Computation of Net Income	

c.

Cash Flow from Operating Activities	

d.

LO 2-2, 2-3, 2-4

Exercise 2-8B *Effect of accruals on the financial statements*

Talley Inc. experienced the following events in Year 1 in its first year of operation:

1. Received $20,000 cash from the issue of common stock.
2. Performed services on account for $38,000.
3. Paid the utility expense of $2,500.
4. Collected $21,000 of the accounts receivable.
5. Recorded $15,000 of accrued salaries at the end of the year.
6. Paid a $2,000 cash dividend to the shareholders.

Required

a. Record the events in general ledger accounts under an accounting equation. In the last column of the table, provide appropriate account titles for the Retained Earnings amounts. The first transaction has been recorded as an example.

TALLEY INC.
General Ledger Accounts

Event No.	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for Ret. Earn.
	Cash	Accounts Receivable	=	Salaries Payable	+	Common Stock	Retained Earnings	
1.	20,000	NA	=	NA	+	20,000	NA	

a.

Talley, Inc.
General Ledger Accounts for the Year Ended December 31, Year 1

	Assets		=	Liabilities	+	Stockholders' Equity		
Event	Cash	Accts. Rec.	=	Salaries Pay.	+	Common Stock	Retained Earnings	Acct. Title for RE
1.	20,000					20,000		
2.								
3.								
4.								
5.								
6.								
Totals	36,500	17,000	=	15,000	+	20,000	18,500	

EXERCISE 2-8B (cont.)

b. Prepare the income statement, statement of changes in stockholders' equity, balance sheet, and statement of cash flows for the Year 1 accounting period.

Talley, Inc.
Income Statement

Talley, Inc.
Statement of Changes in Stockholders' Equity

EXERCISE 2-8B b. (cont.)

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Talley, Inc.
Balance Sheet

EXERCISE 2-8B b. (cont.)

Talley, Inc.
Statement of Cash Flows

c. Why is the amount of net income different from the amount of net cash flow from operating activities?

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Exercise 2-9B ***Effect of accounts receivable and accounts payable transactions on financial statements*** **LO 2-1, 2-2, 2-3, 2-4**

The following events apply to Parker and Moates, a public accounting firm, for the Year 1 accounting period:

1. Performed $96,000 of services for clients on account.
2. Performed $65,000 of services for cash.
3. Incurred $45,000 of other operating expenses on account.
4. Paid $26,000 cash to an employee for salary.
5. Collected $70,000 cash from accounts receivable.
6. Paid $38,000 cash on accounts payable.
7. Paid a $10,000 cash dividend to the stockholders.
8. Accrued salaries were $3,000 at the end of Year 1.

Required

a. Show the effects of the events on the financial statements using a horizontal financial statements model like the following one. In the Statements of Cash Flows column, use OA to designate operating activity, IA for investment activity, FA for financing activity, and NC for net change in cash. Use NA to indicate the element is not affected by the event. The first event is recorded as an example.

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liabilities			+	Equity						
Event	Cash	+	Accts. Rec.	=	Accts. Pay.	+	Sal. Pay.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	
1.	NA	+	96,000	=	NA	+	NA	+	96,000	96,000	−	NA	=	96,000	NA

EXERCISE 2-9B (cont.)

a.

Parker and Moates
Statements Model
Year 1

	Balance Sheet									Income Statement					Statement of
	Assets			=	Liabilities			+	Stk. Equity	Rev.	–	Exp.	=	Net Inc.	Cash Flows
Event	Cash	+	Accts. Rec.	=	Acct. Payable	+	Sal. Pay.	+	Retained Earnings						
1.	NA	+	96,000	=	NA	+	NA	+	96,000	96,000	–	NA	=	96,000	NA
2.															
3.															
4.															
5.															
6.															
7.															
8.															
Totals	61,000	+	26,000	=	7,000	+	3,000	+	77,000	161,000	–	74,000	=	87,000	61,000 NC

EXERCISE 2-9B (cont.)

b. What is the amount of total assets at the end of Year 1?

c. What is the balance of accounts receivable at the end of Year 1?

d. What is the balance of accounts payable at the end of Year 1?

e. What is the difference between accounts receivable and accounts payable?

f. What is net income for Year 1?

g. What is the amount of net cash flow from operating activities for Year 1?

b.

c.

d.

e.

f.

g.

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Exercise 2-10B *Effect of accruals on the financial statements* **LO 2-2, 2-3, 2-4**

Rosewood Inc. experienced the following events in Year 1, its first year of operation:

1. Received $50,000 cash from the issue of common stock.
2. Performed services on account for $67,000.
3. Paid a $5,000 cash dividend to the stockholders.
4. Collected $45,000 of the accounts receivable.
5. Paid $49,000 cash for other operating expenses.
6. Performed services for $10,000 cash.
7. Recognized $2,000 of accrued utilities expense at the end of the year.

Required

a. Identify the events that result in revenue or expense recognition.
b. Based on your response to Requirement *a*, determine the amount of net income reported on the Year 1 income statement.
c. Identify the events that affect the statement of cash flows.
d. Based on your response to Requirement *c*, determine the amount of cash flow from operating activities reported on the Year 1 statement of cash flows.
e. What is the balance of the Retained Earnings account that appears on the Year 1 balance sheet?

a. & c.

Event	Revenue	Expense	Statement of Cash Flows
1.			
2.			
3.			
4.			
5.			
6.			
7.			

b.

Computation of Net Income	

d.

e.

LO 2-2, 2-3, 2-4

Exercise 2-11B *Net income versus changes in cash*

In Year 1, Hall Inc. billed its customers $62,000 for services performed. The company collected $51,000 of the amount billed. Hall incurred $39,000 of other operating expenses on account. Hall paid $31,000 of the accounts payable. Hall acquired $40,000 cash from the issue of common stock. The company invested $21,000 cash in the purchase of land.

Required

(*Hint:* Identify the six events described in the paragraph and record them in general ledger accounts under an accounting equation before attempting to answer the questions.) Use the preceding information to answer the following questions:

a. What amount of revenue will be reported on the Year 1 income statement?

b. What amount of cash flow from revenue will be reported on the statement of cash flows?

c. What is the net income for the period?

d. What is the net cash flow from operating activities for the period?

Hall, Inc.
Effect of Events on the General Ledger Accounts

	Assets			=	Liabilities	+	Stockholders' Equity		
Event	Cash	Accounts Receivable	Land	=	Accounts Payable	+	Com. Stock	+	Retained Earnings
1. Sales on Account									
2. Coll. Accts. Rec.									
3. Incurred Expense									
4. Pd. Acc. Pay.									
5. Issue of Stock									
6. Purchase Land									
Totals	39,000	11,000	21,000	=	8,000	+	40,000	+	23,000

a.

b.

c.

d.

EXERCISE 2-11B (cont.)

e. Why is the amount of net income different from the net cash flow from operating activities for the period?

f. What is the amount of net cash flow from investing activities?

g. What is the amount of net cash flow from financing activities?

h. What amounts of total assets, liabilities, and equity will be reported on the year-end balance sheet?

e.

f.

g.

h.

LO 2-5

Exercise 2-13B *Effects of recognizing accrued interest on financial statements*

Carry Connelly started Connelly Company on January 1, Year 1. The company experienced the following events during its first year of operation:

1. Earned $6,200 of cash revenue.
2. Borrowed $10,000 cash from the bank.
3. Adjusted the accounting records to recognize accrued interest expense on the bank note. The note, issued on September 1, Year 1, had a one-year term and a 9 percent annual interest rate.

Required

a. What is the amount of interest payable at December 31, Year 1?
b. What is the amount of interest expense in Year 1?
c. What is the amount of interest paid in Year 1?
d. Use a horizontal financial statements model to show how each event affects the balance sheet, income statement, and statement of cash flows. Indicate whether the event increases (I), decreases (D), or does not affect (NA) each element of the financial statements. Also, in the Statement of Cash Flows column, designate the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first transaction has been recorded as an example.

	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets	=	Liab.			+	Stk. Equity								
Event	Cash	=	Notes Pay.	+	Int. Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	
1.	I	=	NA	+	NA	+	NA	+	I	I	−	NA	=	I	I OA

a.

b.

c.

d.

Connelly Company
Statements Model for Year 1

	Balance Sheet									Income Statement					Statement of Cash Flows
Event	Assets	=	Liabilities			+	Stockholders' Equity			Rev.	-	Exp.	=	Net Inc.	
No.	Cash	=	Notes Payable	+	Int. Payable	+	Common Stock	+	Ret. Earn.						
1.	I		NA		NA		NA		I	I		NA		I	I OA
2.															
3.															

Exercise 2-14B ***Recognizing accrued interest expense*** **LO 2-5**

California Company borrowed $120,000 from the issuance of a note payable on August 1, Year 1. The note had a 7 percent annual rate of interest and a one-year term to maturity.

Required

a. What amount of interest expense will California recognize for the year ending December 31, Year 1?

b. Show how the recognition of accrued interest expense on December 31, Year 1, affects the accounting equation.

c. What amount of cash will California pay for interest expense in Year 1?

d. What is the amount of interest payable as of December 31, Year 1?

e. What amount of cash will California pay for interest expense in Year 2?

f. What amount of interest expense will California recognize in Year 2?

g. What is the amount of interest payable as of December 31, Year 2?

a.

b.

	Balance Sheet								
	Assets	=	Liabilities			+	Stockholders' Equity		
Event	Cash	=	Notes Payable	+	Int. Payable	+	Common Stock	+	Ret. Earn.
Note									
Adj.									

c.

d.

e.

f.

g.

Exercise 2-15B ***Determine missing amounts in the accounts receivable account*** **LO 2-6**

Required

Determine the missing amounts in each of the following four independent scenarios:

a. W Co. had a $5,000 beginning balance in accounts receivable on January 1, Year 4. During Year 4, the company earned $72,500 of revenue on account and collected $70,000 cash from accounts receivable.

W Co. Accounts Receivable Summary		
Beginning AR Balance		
Increase in AR		
Reduction in AR		
Endings Accounts Receivable Balance		

b. W Co. had a $3,200 ending balance in accounts receivable on December 31, Year 4. During Year 4, the company earned $60,600 of revenue on account and collected $61,200 cash from accounts receivable. Based on this information alone, determine the amount of the beginning balance in accounts receivable.

W Co. Accounts Receivable Summary		
Beginning AR Balance		
Increase in AR		
Reduction in AR		
Endings Accounts Receivable Balance		

EXERCISE 2-15B (cont.)

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c. W Co. had an $11,300 beginning balance in accounts receivable on January 1, Year 4. During Year 4, the company earned $102,400 of revenue on account. The ending balance in accounts receivable was $15,800. Based on this information alone, determine the amount of cash collections from accounts receivable.

W Co. Accounts Receivable Summary		
Beginning AR Balance		
Increase in AR		
Reduction in AR		
Endings Accounts Receivable Balance		

d. W Co. had an $18,000 beginning balance in accounts receivable on January 1, Year 4. During Year 4, the company collected $125,000 of revenue on account. The ending balance in accounts receivable was $28,500. Based on this information alone, determine the amount of cash collections from accounts receivable.

W Co. Accounts Receivable Summary		
Beginning AR Balance		
Increase in AR		
Reduction in AR		
Endings Accounts Receivable Balance		

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Exercise 2-16B *Determine missing amounts in the accounts payable account* **LO 2-6**

Required

Determine the missing amounts in each of the following four independent scenarios:

a. W Co. had a $5,500 beginning balance in accounts payable on January 1, Year 8. During Year 8, the company incurred $45,200 of operating expenses on account and paid $43,100 cash to settle accounts payable. Based on this information alone, determine the amount of the ending balance in accounts payable.

W Co. Accounts Payable Summary		
Beginning accounts payable balance		
Plus:		
Minus:		
Ending accounts payable balance		

b. W Co. had a $5,300 ending balance in accounts payable on December 31, Year 8. During Year 8, the company incurred $55,200 of operating expenses on account and paid $54,600 cash to settle accounts payable. Based on this information alone, determine the amount of the beginning balance in accounts payable.

W Co. Accounts Payable Summary		
Beginning accounts payable balance		
Plus:		
Minus:		
Ending accounts payable balance		

EXERCISE 2-16B (cont.)

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c. W Co. had a $3,000 beginning balance in accounts payable on January 1, Year 8. During Year 8, the company incurred $73,000 of operating expenses on account. The ending balance in accounts payable was $8,500. Based on this information alone, determine the amount of cash paid to settle accounts payable.

W Co. Accounts Payable Summary		
Beginning accounts payable balance		
Plus:		
Minus:		
Ending accounts payable balance		

d. W Co. had a $6,750 beginning balance in accounts payable on January 1, Year 8. During Year 8, the company paid $82,000 cash to settle accounts payable. The ending balance in accounts payable was $10,800. Based on this information alone, determine the amount of expenses incurred on account.

W Co. Accounts Payable Summary		
Beginning accounts payable balance		
Plus:		
Minus:		
Ending accounts payable balance		

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LO 2-6

Exercise 2-17B *Missing information related to accounts receivable*

London Falls Inc. had a beginning balance of $15,000 in its Accounts Receivable account. The ending balance of Accounts Receivable was $8,500. During the period, London Falls collects $65,000 of its accounts receivable. London Falls incurred $53,000 of cash expenses during the accounting period.

Required

a. Based on the information provided, determine the amount of revenue recognized during the accounting period.

b. Based on the information provided, determine the amount of net income earned during the accounting period.

c. Based on the information provided, determine the amount of cash flow from operating activities.

d. Explain why the amounts determined in Requirements *b* and *c* are different.

a.

London Falls Inc. Accounts Receivable Summary	
Beginning AR Balance	
Increase in AR	
Reduction in AR	
Endings Accounts Receivable Balance	

b. **Net income =**

c. **Cash flow from operating activities =**

d.

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LO 2-6

Exercise 2-18B ***Missing information related to accounts payable***

During Year 6, Shelby Enterprises earned $115,000 of cash revenue. The company incurs all operating expenses on account. The Year 6 beginning balance in Shelby's accounts payable account was $25,000 and the ending balance was $18,000. The company made cash payments of $85,000 to reduce accounts payable during Year 6.

Required

a. Based on the information provided, determine the amount of operating expenses recognized during the accounting period.

b. Based on the information provided, determine the amount of net income earned during the accounting period.

c. Based on the information provided, determine the amount of cash flow from operating activities.

d. Explain why the amounts determined in Requirements *b* and *c* are different.

a.

Shelby Enterprises Accounts Payable Summary		
Beginning accounts payable balance		
Plus:		
Minus:		
Ending accounts payable balance		

b. **Net income =**

c. **Cash flow from operating activities =**

d.

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Chapter 2
Accounting for Accruals

General Comments for Chapter 2

Special Note: Some instructors may prefer to delay coverage of notes payable and the accompanying accrual of interest until Chapter 9 which provides in depth coverage of notes payable and the accrual of interest. Chapter 2 is organized so that this strategy can be easily implemented by skipping coverage of Learning Objective 2-5 and the related exercises and problems. You can return to this learning objective when you start coverage of Chapter 9. The content, exercises, and problems are strategically designed to facilitate this strategy.

This chapter introduces the horizontal financial statements model. This model will be used throughout this chapter and the remainder of the text to teach students how accounting events affect financial statements. Accordingly, the model is the first thing you should introduce when you cover Chapter 2. Students should be familiar with financial statements from the coverage provided in Chapter 1. However, if you discover that your students have a poor grasp of financial statements as you enter Chapter 2, we recommend that you return to Chapter 1. This text uses a sequential (stepwise) learning approach. Each new topic represents an extension of the previous topic. If students do not understand step one, they will not understand step two. Accordingly, moving forward when your students are lost is useless. It is more important for students to understand the chapters you cover, than to cover an arbitrary number of chapters.

Explain that the horizontal statements model presents a simplified version of the financial statements. However, instead of showing the information vertically, the information is presented horizontally. The model arranges the balance sheet, income statement, and statement of cash flows horizontally across a single line of text. It does not contain a full set of statements. Specifically, it does not show a statement of changes in stockholders' equity. The model uses abbreviations. It does not include dollar signs or dates. Explain that the model represents a teaching tool that will help them learn to think like business professionals. It is important to distinguish the model from the formal set of financial statements that appear in a company's public reports. A detailed lesson plan for introducing the model is discussed below.

Chapter 2 also introduces the concept of accrual accounting to students. To promote comprehension, we suggest you introduce the subject using a single transaction in which a business provides services on account. Immediately, have the students prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows. Similarly, avoid mixing interest computations with analyzing the effect of interest on the financial statements. Students frequently get so lost in the computational details that they overlook the financial statement effects. Avoid this problem by providing students with the amount of interest, thereby freeing them to focus on its effects. Once students

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understand how accrued interest affects the financial statements, then cover the mechanics of interest computations. Specific examples are provided in the detailed lesson plan outline. If you would like to begin the chapter with a problem-based learning exercise, see the notes below.

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Problem-Based Learning Case: Accrual Accounting

Instructions:

The case appears page 2-4 of this manual. We recommend that you use the case as an introduction to Chapter 2. Copy the case and distribute it to the students as they enter class. Before providing any explanation of accrual accounting ask students to read the case and develop an answer individually. Tell them to not only develop an answer but also provide a logical explanation for the answer they develop. After allowing students time to develop their individual answers, put them into groups to reach consensus on an answer. Also, ask each group to select a spokesperson. Allow groups time to develop answers, then call on some of the spokespersons to share their solutions. Guide the discussion sequentially to produce the following solution:

1. **Identify the effects of revenue recognition:**
   Ask students to identify the revenue event that is described in the case writeup. Specifically, PHI earns $145,000 of revenue which results in $120,000 increase in Cash and a promise to receive $25,000 cash in the future. Provide the name, Accounts Receivable, that is used to describe the $25,000 promise. Continue to follow the practice of introducing terminology as it is needed. The definitions should emerge from the students' response to the problem rather than being provide up prior to the analysis. Students should be encouraged to grapple with the issue of how to record a promise before the recording and statement effects are shown. After allowing time for analysis, instruct students to record the event in an accounting equation.

2 **Identify the effects of expense recognition:**
   In the second event PHI incurs $80,000 of expenses. As a result, Cash decreased by $75,000 and the company accepts a $5,000 obligation. (Accounts Payable). Again, introduce the term only after students identified a need for the term. Show the effects of the expense recognition in an accounting equation. Make note of the fact that expenses cause decreases in assets or ***increases in liabilities***. This expands the definition of expenses provided in Chapter 1. The effects on an accounting equation are shown below:

Accounting Equation									
Events	**Cash**	**+**	**Accts. Rec.**	**=**	**Accts. Pay.**	**+**	**Ret. Earn.**	**Account Titles**
1.	120,000	+	25,000	=	NA	+	145,000	Revenue
2.	(75,000)	+	NA	=	5,000	+	(80,000)	Expense
Totals	45,000	+	25,000	=	5,000	+	65,000	Net Income

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C. Identify key components of financial statements:

Have students determine the amount of Total Assets:
Total Assets: $45,000 Cash + $25,000 Accounts Receivable = $70,000 Total
When making this computation emphasize the fact that Accounts Receivable is an asset.

Have students determine the amount of net income (Revenue $145,000 – Expenses 80,000) and compare that to the amount of cash flow for operating activities (Cash Inflow from Customers of $120,000 - Cash Outflow for Expenses of $75,000). Explain that differences such as these are common in accrual accounting.

You may want to carry the discussion further by having student create a balance sheet thereby providing an opportunity to see where receivables and payables appear on that financial statement. You should remain flexible with PBL cases, allowing the class reaction to guide your discussion. Have a plan but do not hesitate to venture from that plan.

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Chapter 2 Problem-Based Learning Case: Accrual Accounting

Professional Headhunters, Inc. (PHI), is a job placement company that operates in the northeastern United States. During Year 1 the company earned $145,000 in revenue by providing services to customers. However, it collected only $120,000 of the revenue in cash. PHI expected to collect the remaining $25,000 in Year 2. In addition, PHI incurred $80,000 of expenses. However, by the end of Year 1, PHI had paid only $75,000 of the cash owed for expenses because it had not yet paid $5,000 to employees who had worked during Year 1 but had not been paid by the end of the year. PHI expected to pay the $5,000 in cash to the employees during Year 2. Based on this information alone, determine the amount of total assets, total liabilities, net income, and cash flow from operations that PHI should report on its Year 1 financial statements.

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Detailed Outline of a Lesson Plan for Chapter 2

I. **Introduce the horizontal financial statements model.** Use Demonstration Problem 2-1 to introduce students to the horizontal financial statements model. Take note that Demonstration Problem 2-1 is the same problem used as Demonstration Problem 1-1. It is important for students to understand that we are choosing to display the same information in a different format. Demonstration Problem 1-1 and the other Chapter 2 demonstration problems for this chapter are shown in the next section of this manual.

Engage your class by telling your students that the primary objective of the model is to teach them to think like business professionals. Business professionals tend to think about bottom-line consequences: If I do this or that, how will it affect my company's net income, total assets, cash flow, and so on. This type of thinking occurs whether you work in accounting, management, marketing, finance, insurance, real estate, or virtually any other area of business. Accordingly, learning to mimic this thinking approach benefits all business students regardless of whether they are accounting majors.

Show the horizontal model contained in Demonstration Problem 2-1 using the display equipment available in your classroom. Assuming that the necessary equipment is available, we recommend using an e-transparency. However, you can draw the model on a chalk board if electronic equipment is not available. Explain that the model is designed to show how individual accounting events affect financial statements. Note that the model does not represent a complete set of financial statements. The statement of changes in stockholders' equity is missing. It does not included dates, dollar signs, or other technical features that are presented in formal financial statements. Demonstrate the features of the model by recording the Year 1 events in the model in front of the class. Then assign students the task of recording Year 2 events in the model. Walk around the room offering to help as students attempt to record the Year 2 events. After the majority of the class has completed the Year 2 transactions, you should provide the solution. Tell those who have the correct answers to move on to the Year 3 events while you help those that are having trouble. Year 3 events can be assigned as a homework assignment for those who are unable to finish the problem in class. If necessary, students can hand draw the forms. However, to save time we recommend that you use the work papers that are provided in the teaching materials section of this guide.

Take a proactive posture as you walk around the room while students are working. Students are accustomed to the traditional lecture format where the teacher stands at a podium in the front of the room. They are reluctant to ask questions directly to the instructor. So instead of waiting for them to call on you, you should observe those that appear to be having difficulty and approach them. Ask if you can help.

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How do you know if they are having difficulty? Many times, it is the student that is playing with their phone, talking to their peers, or otherwise ignoring the assignment. Disinterest is frequently the result of a lack of understanding. If you want you students to be engaged, make sure that they comprehend the subject matter.

II. **Introduce accrual accounting by writing the following event on the chalkboard.** Alternatively, you can duplicate and pass out Demonstration Problem 2-2.

*Packard Consultants was started in Year 1 when it provided $5,000 of services **on account**.*

A. It will be necessary to explain the meaning of the phrase ***on account***. Tell students this means that Packard recognizes the revenue before it collects the cash. In other words, revenue is recognized in the accounting period in which the work is done regardless of when cash changes hands. This discussion should lead to defining the term accrual. In general, transactions in which a revenue or expense is recognized before cash changes hands are termed ***accruals***. Demonstrate this point by recording the revenue recognition for Packard in a horizontal financial statements model like the one shown below. Highlight the difference between net income and cash flow from operating activities.

	Balance Sheet								Income Statement					Statement of Cash Flow
Year	**Cash**	**+**	**Acct. Rec.**	**=**	**Liab.**	**+**	**Equity**		**Rev.**	**−**	**Exp.**	**=**	**Net Inc.**	
1	n/a	+	5,000	=	n/a	+	5,000		5,000	−	n/a	=	5,000	n/a

To reinforce the difference between a horizontal financial statement model and format financial statements, have your students prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows. To minimize the time required for this task, you may want to provide students with copies of the work paper for Demonstration Problem 2-2. As indicated earlier the work papers are located in the Teaching Materials Section at the end of this manual.

B. Since there were no stock issues during Year 1, the statement of changes in stockholders' equity becomes a statement of retained earnings. While the text does not cover a statement of retained earnings, students should be able to infer the format from their experience with the statement of changes in stockholders' equity. Use the exercise to discuss diversity in reporting practice. Students should learn that while there is general consistency in financial reporting, there is also variety. They need to understand differences in reporting formats.

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C. After accounting for the revenue recognition, assume that Packard collects the $5,000 account receivable in Year 2. Assume that this is the only Year 2 transaction. Have the students record the event in a horizontal financial statements model and prepare the four basic financial statements for the Year 2 accounting period. Encourage students to analyze the difference in the amounts shown in the income statement versus the amounts shown as operating activities in the statement of cash flows. This single transaction clearly illustrates differences between the income statement and the statement of cash flows.

	Balance Sheet								Income Statement					Statement of Cash Flow
Year	Cash	+	Acct. Rec.	=	Liab.	+	Equity		Rev.	−	Exp.	=	Net Inc.	
1	n/a	+	5,000	=	n/a	+	5,000		5,000	−	n/a	=	5,000	n/a
2	5,000	+	(5,000)	=	n/a	+	n/a		n/a	−	n/a	=	n/a	+5,000 OA

III. **Use Demonstration Problem 2-3 to introduce *accrued interest*.** Master copies of the problem, solution, and work papers are located in the Teaching Materials Section at the end of this manual. The following description of the transactions includes for the instructor explanatory comments in italics.

A. Events for Year 2 are as follows:

1. Canton Company borrowed $10,000 cash from the National Bank on September 1, Year 2. *The list of transactions does not involve common stock, dividends, or other superfluous elements that are not germane to the subject of interest. Whenever possible, use an isolated set of transactions that focuses on a specific topic. When multiple topics are introduced simultaneously, students may experience information overload, which leads to memorization. This problem focuses on borrowing funds, using the borrowed funds to buy land, and matching the rent revenue with the interest expense.*
2. Canton invested the borrowed money in land.
3. Canton earned rent revenue of $600 cash.
4. As of December 31, Year 2, accrued interest (interest expense) on Canton's bank loan was $400. *The amount of interest is provided for the student. The focus is to learn how interest expense affects the financial statements. Computing the amount of interest will be addressed in a subsequent problem. Once again, the objective is to avoid introducing too many topics simultaneously. Use this entry to expand the definition of an expense. Note that the increase in the liability account is paired with expense recognition.* ***Define expenses as decreases in assets or increases in liabilities.***

Require your students to record the events under an accounting equation and to prepare financial statements for the accounting period ended December 31, Year 2.

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B. After preparing the Year 2 statements, assume these Year 3 events:
   1. Canton earned rent revenue of $1,350 cash in Year 3.
   2. Canton sold its land for $10,000 cash.
   3. Canton accrued interest of $800 on the bank loan. *The accrual of interest and the payment of interest are shown as separate transactions. While combining transactions reduces the time necessary to record transactions in a manual accounting system, doing so masks the logical sequence of the steps. Since the objective is to teach students to understand accounting rather than how to save time recording transactions, avoid complex entries.*
   4. Canton paid cash for the interest due on the bank loan.
   5. Canton repaid the $10,000 bank loan with cash.

IV. Hand out Demonstration Problem 2-4. After you have shown students how accrued interest affects the accounting equation and the financial statements in Demonstration Problem 2-3, use Demonstration Problem 2-4 to show them how to compute accrued interest.

Demonstration Problem 2-4 Accrued Interest Computations
Johnson Company borrowed $1,000 cash by issuing a one-year note to the State Bank. The bank charged Johnson interest on the note at a 12 percent annual rate. Determine the amount of accrued interest expense Johnson would report at December 31, Year 2 under each of the three following independent assumptions. The note was issued (money was borrowed) on (1) April 1, Year 2; (2) June 1, Year 2; and (3) October 1, Year 2.

Solution:

Date	Principal	x	Rate	x	Time	=	Accrued Interest
April 1, Year 2	$1,000	x	.12	x	9/12	=	$90
June 1, Year 2	$1,000	x	.12	x	7/12	=	$70
Oct. 1, Year 2	$1,000	x	.12	x	3/12	=	$30

V. Time considerations and homework assignments.

Recall that there are two sets of exercises and problems (Set A and Set B) in the end of each chapter of the text materials. As a general rule, we use Set B exercises and problems in the classroom and reserve the Set A equivalent exercises and problems as homework. We reserve Set A exercises and problems for homework because they are included in McGraw-Hill's Connect, electronic homework management system.

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Plan to spend at least one hour on Demonstration Problem 2-1. Use Exercises 2-1A&B for reinforcement. Note that these exercises require students to record events in a horizontal financial statements model and then to prepare formal financial statements. Accordingly, they provides an excellent opportunity to distinguish the statements model from formal financial statements. Exercises 2-2A&B and 2-3A&B can be used as further reinforcement. Since the horizontal financial statement model will be used extensively throughout the text, we highly recommend that you spend considerable time introducing the topic and reinforcing it use.

Completing Demonstration Problems 2-2, 2-3, and 2-4 should require approximately one hour of class time. Remember to have the students work along with you as you explain the problems. For example, in Demonstration Problem 2-4 you can show them the computations for the assumption that the note was issued on April 1, and then have them calculate the interest for the other two issue dates. Use Exercises 2-4A&B, 2-5A&B, and 2-6A&B to reinforce the accrual concepts associated with accounts receivable and accounts payable. Exercises 2-13A&B, and 2-14A&B can be used to reinforce the concepts associated with accrued interest. Based on time available, students can work these exercises in class or as homework.

VI. Use Demonstration Problem 2-5 as a comprehensive summary problem. This is a two-cycle problem. Explain the first cycle (Year 1) and then use the second cycle (Year 2) as an in-class assignment. Allot approximately one hour to complete this assignment. Students needing additional time can finish the problem as homework. Problem 2-23A mirrors the demonstration problem and can be used as homework assignments.

VII. Enrichment. Given time constraints, choose enrichment topics with care. Students benefit from early exposure to the cases involving the Target Annual Report, especially during the first three chapters. The ethics cases provoke interest and you may prefer to use them. We prefer to concentrate on understanding how accounting events affect financial statements early in the course and to address more subjective issues (ethics cases) later in the course. Accordingly, we suggest you cover case ATC 2-1 if there is time. This case is contained in the section of the problem material titled Analyze, Think, and Communicate which is located in the text immediately behind the B Set of Exercises and Problems.

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Demonstration Problems for Chapter 2

Demonstration Problem 2-1: The Accounting Cycle

The events below apply to Computer Services Company (CSC). Assume that all transactions involve receiving or paying cash.

Transactions for the Year 1:
1. CSC was started when it acquired $9,000 cash by issuing common stock.
2. The company borrowed $5,000 from a bank.
3. The company provided services to customers and received $4,000.
4. The company paid operating expenses of $2,900.
5. The company paid $500 in dividends to its stockholders.

Transactions for the Year 2:
1. The company issued additional common stock for $4,500.
2. The company paid $2,000 to reduce its liabilities.
3. The company provided services to customers and received $6,700.
4. The company paid operating expenses of $4,300.
5. The company paid $700 in dividends to its stockholders.

Transactions for the Year 3:
1. The company issued additional common stock for $2,500.
2. The company borrowed an additional $1,000 from creditors.
3. The company provided services to customers and received $7,400.
4. The company paid operating expenses of $7,900.
5. The company paid $300 in dividends to its stockholders.
6. The company paid $21,000 to purchase land.

Required

Record the events in a horizontal financial statements model. In the statement of cash flows column use OA to indicate operating activities, IA to indicate investing activities, and FA to indicate financing activities.

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Demonstration Problem 2-2: Revenue Earned on Account

Year 1
Packard Consultants was started in Year 1. During that year the company earned $5,000 of consulting revenue ***on account***. Assume this is the only event experienced by Packard during Year 1.

Required
a. Record the event under an accounting equation.
b. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for Year 1.

Year 2
During Year 2, Packard Consultants collected $5,000 cash from the account receivable it established in Part A.

Required
a. Record the event under an accounting equation.
b. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for Year 2.

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Demonstration Problem 2-3: Accrued Interest on Financial Statements

Year 1
Canton Company experienced the following accounting events during Year 1:

1. Canton Company borrowed $10,000 cash from the National Bank on September 1, Year 1.
2. Canton invested the borrowed money in land.
3. Canton earned rent revenue of $600 cash.
4. As of December 31, Year 1, accrued interest (interest expense) on Canton's bank loan was $400.

Required
a. Record the events under an accounting equation.
b. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for Year 1.

Year 2
Canton Company experienced the following accounting events during Year 2:

1. Canton earned rent revenue of $1,350 cash in Year 2.
2. Canton sold its land for $10,000 cash.
3. Canton accrued interest of $800 on the bank loan.
4. Canton paid cash for the interest due on the bank loan.
5. Canton repaid the $10,000 bank loan with cash.

Required
a. Record the events under an accounting equation.
b. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for Year 2.

Demonstration Problem 2-4: Accrued Interest Computations

During Year 1, Johnson Company borrowed $1,000 cash by issuing a one-year note to the State Bank. The bank charged Johnson interest on the note at a 12 percent annual rate.

Required
Determine the amount of accrued interest expense Johnson would report at December 31, Year 1 under each of the three following independent assumptions. The note was issued (money was borrowed) on (1) April 1; (2) June 1; and (3) October 1.

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Demonstration Problem 2-5 Accruals Comprehensive Problem

Smith Company experienced the following accounting events during Year 1:

1. Smith Company was started when it issued common stock for $2,000 cash.
2. Smith borrowed $1,000 cash from Allied Bank. Smith issued a note payable on as evidence of it obligation to repay the loan.
3. During the year, the company recognized $1,500 of consulting revenue on account.
4. The company collected $1,200 cash from accounts receivable.
5. Accrued salary expense during the year of $900.
6. Paid $700 of the salaries payable liability.
7. Paid dividends of $100 to the stockholders.
8. Smith adjusted the books to recognize accrued interest expense. The note was issued on September 1, Year 1. It had a 6 percent annual interest rate and a one-year term. The company's fiscal period ends on December 31 of each year.

Smith Company experienced the following accounting events during Year 2:

1. Smith Company issued additional common stock for $3,000 cash.
2. During the period there was $2,700 of consulting revenue recognized on account.
3. Collected $2,800 cash from accounts receivable.
4. Accrued salary expenses of $1,500.
5. Paid $1,350 of the salaries payable liability.
6. Paid dividends of $300 cash to the stockholders.
7. On August 31 Smith (a) accrued the remaining interest on the note payable, (b) paid the cash due for interest payable, and (c) paid off the $1,000 note payable.
8. On November 1, Smith purchased land for $6,000 cash.
9. The land had a market value of $6,400 as of December 31, Year 2.

Required

a. Record the events under an accounting equation.
b. Prepare an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows for Year 1 and Year 2.
c. Use a horizontal financial statements model to show how the events for Year 1 and Year 2 affect financial statements. Use a plus sign to indicate an increase, a minus sign to indicate a decrease, the initials NA to indicate not affected. In the statement of cash flows column use, a plus sign to indicate a cash inflow, a minus sign to indicate a cash outflow. Also, use OA to indicate operating activities, IA to indicate investing activities, and FA to indicate financing activities.

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Solutions for Chapter 2 Demonstration Problems

Demonstration Problem 2-1

	Balance Sheet									Income Statement					Statement of Cash Flow
Year 1	Assets			=	Liab.	+	Equity								
No.	Cash	+	Land	=	N. Pay.	+	C. Stk.	+	Ret. Earn.	Rev.	–	Exp.	=	Net Inc.	
Beg. bal.	0	+	0	=	0	+	0	+	0	0	–	0	=	0	NA
1	9,000	+	NA	=	NA	+	9,000	+	NA	NA	–	NA	=	NA	9,000 FA
2	5,000	+	NA	=	5,000	+	NA	+	NA	NA	–	NA	=	NA	5,000 FA
3	4,000	+	NA	=	NA	+	NA	+	4,000	4,000	–	NA	=	4,000	4,000 OA
4	(2,900)	+	NA	=	NA	+	NA	+	(2,900)	NA	–	2,900	=	(2,900)	(2,900) OA
5	(500)	+	NA	=	NA	+	NA	+	(500)	NA	–	NA	=	NA	(500) FA
Totals	14,600	+		=	5,000	+	9,000	+	600	4,000	–	2,900	=	1,100	14,600 NC
Year 2	Assets			=	Liab.	+	Equity								
No.	Cash	+	Land	=	N.Pay.	+	C. Stk.	+	Ret. Ear.	Rev.	–	Exp.	=	Net Inc.	Cash Flow
Beg. bal.	14,600	+		=	5,000	+	9,000	+	600		–		=		
1	4,500	+		=		+	4,500	+			–		=		4,500 FA
2	(2,000)	+		=	(2,000)	+		+			–		=		(2,000) FA
3	6,700	+		=		+		+	6,700	6,700	–		=	6,700	6,700 OA
4	(4,300)	+		=		+		+	(4,300)		–	4,300	=	(4,300)	(4,300) OA
5	(700)	+		=		+		+	(700)		–		=		(700) FA
Totals	18,800	+		=	3,000	+	13,500	+	2,300	6,700	–	4,300	=	2,400	4,200 NC
Year 3	Assets			=	Liab.	+	Equity								
No.	Cash	+	Land	=	N.Pay.	+	C. Stk.	+	Ret. Ear.	Rev.	–	Exp.	=	Net Inc.	Cash Flow
Beg. bal.	18,800	+		=	3,000	+	13,500	+	2,300		–		=		
1	2,500	+		=		+	2,500	+			–		=		2,500 FA
2	1,000	+		=	1,000	+		+			–		=		1,000 FA
3	7,400	+		+		+		+	7,400	7,400	–		=	7,400	7,400 OA
4	(7,900)	+		+		+		+	(7,900)		–	7,900	=	(7,900)	(7,900) OA
5	(300)	+		+		+		+	(300)		–		=		(300) FA
6	(21,000)	+	21,000	+		+		+			–		=		(21,000) IA
Totals	500	+	21,000	+	4,000	+	16,000	+	1,500	7,400	–	7,900	=	(500)	(18,300) NC

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Demonstration Problem 2-2: Requirement a

	Assets			=	Liabilities	+	Equity		
Year 1	**Cash**	+	**Accts. Receiv.**	=	**Liabilities**	+	**Common Stock**	+	**Retained Earnings**
Beginning Balances	$ -0-		$ -0-		$ -0-		$ -0-		$ -0-
1. Effect of Recognizing Rev.			5,000						5,000
Year 2									
1. Effect of Cash Collection	5,000		(5,000)						
Ending Balances	$5,000	+	$ -0-	=	$ -0-	+	$ -0-	+	$5,000

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Demonstration Problem 2-2: Requirement b

Packard Consultants		
Income Statements		
For the Years Ended December 31,	Year 1	Year 2
Consulting Revenue	$5,000	$-0-
Expenses	-0-	-0-
Net Income	$5,000	$-0-
Statements of Retained Earnings		
Beginning Retained Earnings	$ -0-	$5,000
Net Income	$5,000	-0-
Dividends	-0-	-0-
Ending Retained Earnings	$5,000	$5,000
Balance Sheets at December 31		
Assets		
Cash	$ -0-	$5,000
Accounts Receivable	5,000	-0-
Total Assets	$5,000	$5,000
Equity		
Retained Earnings	$5,000	$5,000
Statements of Cash Flows		
Cash Flows from Operating Activities	$ -0-	$5,000
Cash Flows from Investing Activities	-0-	-0-
Cash Flows from Financing Activities	-0-	-0-
Net Change in Cash	-0-	$5,000
Beginning Cash Balance	-0-	-0-
Ending Cash Balance	$ -0-	$5,000

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Demonstration Problem 2-3: Requirement a

	Assets			=	Liab.			+	Equity		
Year 1	Cash	+	Land	=	Notes Payable	+	Int. Pay.	+	Com. Stock	+	Ret. Ear.
Beginning Balances	$ -0-		$ -0-		$ -0-		$ -0-		$ -0-		$ -0-
1. Effect of Borrowing	10,000				10,000						
2. Purch. of Land	(10,000)		10,000								
3. Earned Revenue	600										600
4. Accrued Int. Exp.							400				(400)
End. / Beg. Balances	$ 600	+	$10,000	=	$10,000	+	$ 400	+	$ -0-	+	$ 200
Year 2											
1. Earned Revenue	1,350										1,350
2. Sold Land	10,000		(10,000)								
3. Accrued Int. Exp.							800				(800)
4. Paid Interest	(1,200)						(1,200)				
5. Repaid Loan	(10,000)				(10,000)						
Ending Balances	$ 750	+	$ -0-	=	$ -0-	+	$ -0-	+	$ -0-	+	$ 750

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Demonstration Problem 2-3: Requirement b

Canton Company		
Income Statements		
For the Years Ended December 31,	Year 1	Year 2
Rent Revenue	$600	$1,350
Interest Expense	(400)	(800)
Net Income	$200	$550
Statements of Retained Earnings		
Beginning Retained Earnings	-0-	$200
Net Income	$200	550
Dividends	-0-	-0-
Ending Retained Earnings	$200	$750
Balance Sheets at December 31		
Assets		
Cash	$ 600	$750
Land	10,000	-0-
Total Assets	$10,600	$750
Liabilities		
Interest Payable	$ 400	-0-
Note Payable	10,000	-0-
Equity		
Retained Earnings	200	$750
Total Liabilities and Equity	$10,600	$750
Statements of Cash Flows		
Cash Flows from Operating Activities		
Inflow from Rental Income	$ 600	$ 1,350
Outflow for Interest Expense	-0-	(1,200)
Net Inflow from Operating Activities	$ 600	$ 150
Cash Flow from Investing Activities		
Inflow from Sale of Land	-0-	$10,000
Outflow for Purchase of Land	(10,000)	-0-
Net Inflow (Outflow) from Investing Act.	(10,000)	$10,000
Cash Flows from Financing Activities		
Inflow from Issue of Note	10,000	-0-
Outflow for Repayment of Note	-0-	$(10,000)
Net Inflow (Outflow) from Financing Act.	10,000	$(10,000)
Net Change in Cash	600	$ 150
Beginning Cash Balance	-0-	600
Ending Cash Balance	$ 600	$ 750

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Demonstration Problem 2-4

Johnson's Year 1 interest expense is determined as follows:

Date Note Issued	Principal	x	Rate	x	Time	=	Accrued Interest
April 1, Year 1	$1,000	x	.12	x	(9 ÷ 12)	=	$90
June 1, Year 1	$1,000	x	.12	x	(7 ÷ 12)	=	$70
October 1, Year 1	$1,000	x	.12	x	(3 ÷ 12)	=	$30

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Demonstration Problem 2-5: Requirement a

	ASSETS			=	LIABILITIES			+	EQUITY	
Year 1		**Accts.**			**Sal.**	**Int.**	**Note**		**Com.**	**Ret.**
Accounting Events	**Cash**	**Rec.**	**Land**	**=**	**Pay.**	**Pay.**	**Pay.**	**+**	**Stk.**	**Ear.**
Beginning Balances	-0-	-0-	-0-		-0-	-0-	-0-		-0-	-0-
(1) Issued Common Stock	2,000								2,000	
(2) Issued Note Payable	1,000						1,000			
(3) Recognized Consulting Rev.		1,500								1,500
(4) Collected Cash from Rec.	1,200	(1,200)								
(5) Recognized Salary Expense					900					(900)
(6) Paid Liability for Salaries	(700)				(700)					
(7) Paid Dividends	(100)									(100)
(8) Recognized Accrued Int. Exp.						20				(20)
Ending Balances	3,400	300	-0-		200	20	1,000		2,000	480

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Demonstration Problem 2-5: Requirement a

	ASSETS			=	LIABILITIES			+	EQUITY	
Year 2		Accts.			Sal.	Int.	Note		Com.	Ret.
Accounting Events	Cash	Rec.	Land	=	Pay.	Pay.	Pay.	+	Stk.	Ear.
Beginning Balances	3,400	300	0		200	20	1,000		2,000	480
(1) Issued Common Stock	3,000								3,000	
(2) Recognized Consulting Rev.		2,700								2,700
(3) Collected Cash from Rec.	2,800	(2,800)								
(4) Recognized Salary Expense					1,500					(1,500)
(5) Partial Payment of Sal. Pay.	(1,350)				(1,350)					
(6) Paid Dividends	(300)									(300)
(7a) Recognized Accrued Int. Exp.						40				(40)
(7b) Paid off Interest Payable	(60)					(60)				
(7c) Paid off Note Payable	(1,000)						(1,000)			
(8) Purchased Land	(6,000)		6,000							
(9) Change in Market Value (no effect)										
Ending Balances	490	200	6,000		350	0	0		5,000	1,340

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Demonstration Problem 2-5: Requirement b

Income Statements for the Years Ended 12/31	Year 1	Year 2
Consulting Revenue	$1,500	$2,700
Salary Expense	(900)	(1,500)
Interest Expense	(20)	(40)
Net Income	$ 580	$1,160
Statements of Changes in Stockholders' Equity		
Beginning Common Stock	$ -0-	$2,000
Plus: Common Stock Issued	2,000	3,000
Ending Common Stock	2,000	5,000
Beginning Retained Earnings	-0-	480
Plus: Net Income	580	1,160
Less: Dividends	(100)	(300)
Ending Retained Earnings	480	1,340
Total Stockholders' Equity	$2,480	$6,340
Balance Sheets as of December 31		
Cash	$3,400	$ 490
Accounts Receivable	300	200
Land	-0-	6,000
Total Assets	$3,700	6,690
Salaries Payable	$ 200	$ 350
Interest Payable	20	0
Note Payable	1,000	0
Total Liabilities	1,220	350
Common Stock	2,000	5,000
Retained Earnings	480	1,340
Total Stockholders' Equity	2,480	6,340
Total Liabilities and Stockholders' Equity	$3,700	$6,690
Statements of Cash Flows		
Cash Flows from Operating Activities		
Cash Receipts from Consulting Revenue	$ 1,200	$2,800
Cash Payments for Salaries	(700)	(1,350)
Cash Payments for Interest Expense		(60)
Net Cash Inflow from Operating Activities	500	1,390
Cash Flows from Investing Activities		
Cash Payment to Purchase Land	-0-	(6,000)
Net Cash Outflow from Investing Activities	-0-	(6,000)
Cash Flows from Financing Activities		
Cash Payment to Settle Note Payable	1,000	(1,000)
Cash Receipt from Common Stock Issue	2,000	3,000
Cash Payment for Dividends	(100)	(300)
Net Cash Inflow from Financing Activities	2,900	1,700
Net Change in Cash	3,400	(2,910)
Beginning Cash Balance	-0-	3,400
Ending Cash Balance	$3,400	$ 490

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Demonstration Problem 2-5: Requirement c

Year 1

Event No.	Assets	= Liabilities	+ Stk. Equity	Rev.	− Exp.	= Net Inc.	Statement of Cash Flow
1	+	NA	+	NA	NA	NA	+ FA
2	+	+	NA	NA	NA	NA	+ FA
3	+	NA	+	+	NA	+	NA
4	+ −	NA	NA	NA	NA	NA	+ OA
5	−	NA	−	NA	+	−	NA
6	−	−	NA	NA	NA	NA	− OA
7	−	**NA**	−	NA	NA	NA	− FA
8		+	−	NA	+	−	NA

Year 2

Event No.	Assets	= Liabilities	+ Stk. Equity	Rev.	− Exp.	= Net Inc.	Statement of Cash Flow
1	+	NA	+	NA	NA	NA	+ FA
2	+	NA	+	+	NA	+	NA
3	+ −	NA	NA	NA	NA	NA	+ OA
4	−	NA	−	NA	+	−	NA
5	−	−	NA	NA	NA	NA	− OA
6	−	NA	−	NA	NA	NA	− FA
7a	NA	+	−	NA	+	−	NA
7b	−	−	NA	NA	NA	NA	− OA
7c	−	−	NA	NA	NA	NA	− FA
8	+ −	NA	NA	NA	NA	NA	− IA
9	NA	NA	NA	NA	NA	NA	NA

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Workpapers for Chapter 2 Demonstration Problems

Demonstration Problem 2-1

	Balance Sheet									Income Statement					Statement of Cash Flow
Year 1	Assets			=	Liab.	+	Equity								
No.	Cash	+	Land	=	N. Pay.	+	C. Stk.	+	Ret. Earn.	Rev.	–	Exp.	=	Net Inc.	
Beg. bal.	0	+	0	=	0	+	0	+	0	0	–	0	=	0	NA
1	9,000	+	NA	=	NA	+	9,000	+	NA	NA	–	NA	=	NA	9,000 FA
2															
3															
4															
5															
Totals	14,600	+		=	5,000	+	9,000	+	600	4,000	–	2,900	=	1,100	14,600 NC
Year 2	Assets			=	Liab.	+	Equity								
No.	Cash	+	Land	=	N.Pay.	+	C. Stk.	+	Ret. Ear.	Rev.	–	Exp.	=	Net Inc.	Cash Flow
Beg. bal.															
1															
2															
3															
4															
5															
Totals	18,800	+		=	3,000	+	13,500	+	2,300	6,700	–	4,300	=	2,400	4,200 NC
Year 3	Assets			=	Liab.	+	Equity								
No.	Cash	+	Land	=	N.Pay.	+	C. Stk.	+	Ret. Ear.	Rev.	–	Exp.	=	Net Inc.	Cash Flow
Beg. bal.															
1															
2															
3															
4															
5															
6															
Totals	500	+	21,000	+	4,000	+	16,000	+	1,500	7,400	–	7,900	=	(500)	(18,300) NC

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Demonstration Problem 2-2: Requirement a

	Assets			=	Liabilities	+	Equity		
Year 1	Cash	+	Accts. Receiv.	=	Liabilities	+	Common Stock	+	Retained Earnings
Beginning Balances	$ -0-		$ -0-		$ -0-		$ -0-		$ -0-
1. Effect of Recognizing Rev.									
Year 2									
1. Effect of Cash Collection									
Ending Balances	$5,000	+	$ -0-	=	$ -0-	+	$ -0-	+	$5,000

Demonstration Problem 2-2: Requirement b

Packard Consultants		
Income Statements		
For the Years Ended December 31,	Year 1	Year 2
Consulting Revenue		
Expenses		
Net Income		
Statements of Retained Earnings		
Beginning Retained Earnings		
Net Income		
Dividends		
Ending Retained Earnings		
Balance Sheets at December 31		
Assets		
Cash		
Accounts Receivable		
Total Assets		
Equity		
Retained Earnings		
Statements of Cash Flows		
Cash Flows from Operating Activities		
Cash Flows from Investing Activities		
Cash Flows from Financing Activities		
Net Change in Cash		
Beginning Cash Balance		
Ending Cash Balance		

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Demonstration Problem 2-3: Requirement a

	Assets			=	Liab.			+	Equity		
Year 1	Cash	+	Land	=	Notes Payable	+	Int. Pay.	+	Com. Stock	+	Ret. Ear.
Beginning Balances	$ -0-		$ -0-		$ -0-		$ -0-		$ -0-		$ -0-
1. Effect of Borrowing											
2. Purch. of Land											
3. Earned Revenue											
4. Accrued Int. Exp.											
	———		———		———		———		———		———
End. / Beg. Balances	$ 600	+	$10,000	=	$10,000	+	$ 400	+	$ -0-	+	$ 200
Year 2											
1. Earned Revenue											
2. Sold Land											
3. Accrued Int. Exp.											
4. Paid Interest											
5. Repaid Loan											
	———		———		———		———		———		———
Ending Balances	$ 750	+	$ -0-	=	$ -0-	+	$ -0-	+	$ -0-	+	$ 750
	═══		═══		═══		═══		═══		═══

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Demonstration Problem 2-3: Requirement b

Canton Company		
Income Statements		
For the Years Ended December 31,	Year 1	Year 2
Rent Revenue		
Interest Expense		
Net Income	$200	$550
Statements of Retained Earnings		
Beginning Retained Earnings		
Net Income		
Dividends		
Ending Retained Earnings	$200	$750
Balance Sheets at December 31		
Assets		
Cash		
Land		
Total Assets		
Liabilities		
Interest Payable		
Note Payable		
Equity		
Retained Earnings		
Total Liabilities and Equity	$10,600	$750
Statements of Cash Flows		
Cash Flows from Operating Activities		
Inflow from Rental Income		
Outflow for Interest Expense		
Net Inflow from Operating Activities		
Cash Flow from Investing Activities		
Inflow from Sale of Land		
Outflow for Purchase of Land		
Net Inflow (Outflow) from Investing Act.		
Cash Flows from Financing Activities		
Inflow from Issue of Note		
Outflow for Repayment of Note		
Net Inflow (Outflow) from Financing Act.		
Net Change in Cash		
Beginning Cash Balance		
Ending Cash Balance	$ 600	$ 750

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Demonstration Problem 2-4

Johnson's Year 1 interest expense is determined as follows:

Date Note Issued	Principal	x	Rate	x	Time	=	Accrued Interest
April 1, Year 1							
June 1, Year 1							
October 1, Year 1							

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Demonstration Problem 2-5: Requirement a

	ASSETS			=	LIABILITIES			+	EQUITY	
Year 1		**Accts.**			**Sal.**	**Int.**	**Note**		**Com.**	**Ret.**
Accounting Events	**Cash**	**Rec.**	**Land**	=	**Pay.**	**Pay.**	**Pay.**	+	**Stk.**	**Ear.**
Beginning Balances	**-0-**	**-0-**	**-0-**		**-0-**	**-0-**	**-0-**		**-0-**	**-0-**
(1) Issued Common Stock										
(2) Issued Note Payable										
(3) Recognized Consulting Rev.										
(4) Collected Cash from Rec.										
(5) Recognized Salary Expense										
(6) Paid Liability for Salaries										
(7) Paid Dividends										
(8) Recognized Accrued Int. Exp.										
Ending Balances	**3,400**	**300**	**-0-**		**200**	**20**	**1,000**		**2,000**	**480**

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Demonstration Problem 2-5: Requirement a

	ASSETS			=	LIABILITIES			+	EQUITY	
Year 2		Accts.			Sal.	Int.	Note		Com.	Ret.
Accounting Events	Cash	Rec.	Land	=	Pay.	Pay.	Pay.	+	Stk.	Ear.
Beginning Balances	3,400	300	0		200	20	1,000		2,000	480
(1) Issued Common Stock										
(2) Recognized Consulting Rev.										
(3) Collected Cash from Rec.										
(4) Recognized Salary Expense										
(5) Partial Payment of Sal. Pay.										
(6) Paid Dividends										
(7a) Recognized Accrued Int. Exp.										
(7b) Paid off Interest Payable										
(7c) Paid off Note Payable										
(8) Purchased Land										
(9) Change in Market Value (no effect)										
Ending Balances	490	200	6,000		350	0	0		5,000	1,340

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Demonstration Problem 2-5: Requirement b

Income Statements for the Years Ended 12/31	Year 1	Year 2
Consulting Revenue		
Salary Expense		
Interest Expense		
Net Income	$ 580	$1,160
Statements of Changes in Stockholders' Equity		
Beginning Common Stock	$ -0-	$2,000
Plus: Common Stock Issued		
Ending Common Stock		
Beginning Retained Earnings		
Plus: Net Income		
Less: Dividends		
Ending Retained Earnings		
Total Stockholders' Equity	$2,480	$6,340
Balance Sheets as of December 31		
Cash		
Accounts Receivable		
Land		
Total Assets	$3,700	6,690
Salaries Payable		
Interest Payable		
Note Payable		
Total Liabilities		
Common Stock		
Retained Earnings		
Total Stockholders' Equity		
Total Liabilities and Stockholders' Equity	$3,700	$6,690
Statements of Cash Flows		
Cash Flows from Operating Activities		
Cash Receipts from Consulting Revenue		
Cash Payments for Salaries		
Cash Payments for Interest Expense		
Net Cash Inflow from Operating Activities		
Cash Flows from Investing Activities		
Cash Payment to Purchase Land		
Net Cash Outflow from Investing Activities		
Cash Flows from Financing Activities		
Cash Payment to Settle Note Payable		
Cash Receipt from Common Stock Issue		
Cash Payment for Dividends		
Net Cash Inflow from Financing Activities		
Net Change in Cash		
Beginning Cash Balance		
Ending Cash Balance	$3,400	$ 490

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Demonstration Problem 2-5: Requirement c

Year 1

Event	Balance Sheet			Income Statement			Statement of
No.	Assets =	Liabilities +	Stk. Equity	Rev. −	Exp. =	Net Inc.	Cash Flow
1	+	NA	+	NA	NA	NA	+ FA
2							
3							
4							
5							
6							
7							
8							

Year 2

Event	Balance Sheet			Income Statement			Statement of
No.	Assets =	Liabilities +	Stk. Equity	Rev. −	Exp. =	Net Inc.	Cash Flow
1							
2							
3							
4							
5							
6							
7a							
7b							
7c							
8							
9							

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Quiz Questions for Chapter 2

1. X Company recognized $500 of revenue on account and realized $400 of cash collections. The company had accrued salary expense of $300 and invested $200 in a certificate of deposit. Based on this information alone, the amount of cash flow from operating activities would be
   a. $100.
   b. $500.
   c. $200.
   d. $400.

2. Y Company issued a $5,000 face value note to the State Bank on December 1, Year 2. The note had a 12 percent annual rate of interest and a one-year term. The adjusting entry to record accrued interest on December 31, Year 2, would
   a. decrease liabilities by $50.
   b. decrease equity by $50.
   c. increase net income by $50.
   d. none of the above.

3. On January 1, Year 2, West Company had accounts receivable of $500. During Year 2 West earned $2,500 of service revenue on account. If the accounts receivable balance as of December 31, Year 2, was $400, what was the amount of cash flow from operating activities?
   a. $2,000.
   b. $3,000.
   c. $2,400.
   d. $2,600.

4. On June 1, Year 5 the BBC Company purchased a $5,000 one-year certificate of deposit from the bank. The certificate pays interest at 12 percent annually. On December 31, Year 5 the adjusting entry to record interest on BBC's books would
   a. increase liabilities by $350.
   b. increase net income by $350.
   c. increase assets by $600.
   d. decrease equity by $300.

5. The entry to record revenue on account
   a. increases liabilities.
   b. decreases equity.
   c. decreases assets.
   d. none of the above.

6. On March 1, Year 3, A Company purchased for $5,000 a two-year certificate of deposit that paid 6 percent annual interest. On December 31, Year 3, the adjusting entry to record accrued interest would
   a. increase assets and equity by $500.
   b. increase assets and liabilities by $300.
   c. increase assets and equity by $250.
   d. increase assets and liabilities by $250.

7. K Company collected $500 cash on an account receivable that was due from L Company. Based on this information, which of the following statements is true?
   a. K Company's total assets would increase.
   b. L Company's total assets would not change.
   c. K Company's equity would decrease.
   d. None of the above.

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8. On June 1, Year 2, X Company invested $10,000 in a certificate of deposit. The CD had a 12 percent annual interest rate and a one-year term. For Year 2, X Company would report income on the income statement and cash flow from operating activities on the statement of cash flows, respectively, of
   a. $1,200 / $1,200
   b. $700 / $700
   c. $1,200 / $ 0
   d. $700 / $0

Use the following information to answer the next two questions. On May 1, Year 4, Arrow Company borrowed $10,000 from the State Bank at 9 percent annual interest. The note issued by Arrow had a one-year term. Arrow reported cash revenue of $3,400 and $800 in Year 4 and Year 5, respectively.

9. Arrow's net income for Year 4 and Year 5 would be
   a. $2,500 / $100
   b. $2,800 /$500
   c. $2,400 / $800
   d. $2,500 / $800

10. The cash flow from operating activities Arrow would report on the Year 4 and Year 5 statements of cash flows would be
   a. $2,800 / $500
   b. $2,500 /$800
   c. $2,800 / $(100)
   d. $3,400 / $(100)

11. Which of the following illustrates the recognition of revenue earned on account?

	Balance Sheet					Income Statement					Statement of Cash Flow
	Assets	=	Liab.	+	Equity	Rev.	−	Exp.	=	Net Inc.	
a.	+		n/a		+	n/a		n/a		n/a	n/a
b.	+		n/a		+	+		n/a		+	n/a
c.	−		n/a		−	n/a		+		−	− OA
d.	+		n/a		+	+		n/a		+	+ OA

Question	Ch 2
1	D
2	B
3	D
4	B
5	D
6	C
7	D
8	D
9	B
10	D
11	B

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Summary Outline of a Lesson Plan for Chapter 2

I. **Use Demonstration Problem 2-1 to introduce students to the horizontal financial statements model.**

II. **Use Demonstration Problem 2-2 to define and illustrate the concept of accrual accounting with accounts receivable and accounts payable.**

III. **Use Demonstration Problem 2-3 to introduce *accrued interest*.**

IV. **Use Demonstration Problem 2-4 to illustrate interest computations.**

V. **Time considerations and homework assignments.** Allocate at least one hour to the introduction of the horizontal financial statements model using Demonstration Problem 2-1. Demonstration Problems 2-2, 2-3, and 2-4 also require approximately one hour of class time. From the text use exercises 2-4A&B, 2-5A&B, 2-6A&B, and 2-5A&B for receivables and payables; and 2-13A&B, and 2-14A&B for the treatment of interest.

VI. **Use Demonstration Problem 2-5 as a comprehensive summary problem.** Explain the first cycle (Year 1) to the class and use the second cycle (Year 2) as an in-class assignment. Allot one hour for this assignment. Have slower students finish the problem as homework. Use parallel problem 2-23A&B from the textbook as a homework assignment.

VII. **Enrichment. Use ATC 2-1 in the textbook to cover the topic of audit reports.**

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SOLUTIONS TO ANALYZE, THINK, COMMUNICATE – CHAPTER 2

ATC 2-1 (All dollar amounts are in millions.)

a. Target's accrual accounts are: Accounts payable, Accrued and other current liabilities. The "Other current assets" accounts includes two "Vendor income receivables" and "Income tax and other receivables." See Note 13. As Note 18 shows, all of the individual accounts included in "Accrued and other current liabilities" are accrual accounts.

The "Deferred income taxes" account shown under Liabilities is probably best classified as an accrual account, but students will probably not recognize it as such.

b.

Net income for 2016 was	$2,737
Cash provided by operating activities for 2016 was	$5,436

Thus, cash flow from operating activities exceeded net income by $2,699.

c. Net income decreased by $626 from 2015 to 2016 ($2,737 - $3,363). Cash provided by operating activities decreased by $522 from 2015 to 2016 ($5,436- $5,958). Therefore, the change in net earnings was the greatest.

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ATC 2-2

Income Statments	Year 1	Year 2
Revenue	$50,000	$40,000
Expense	(30,000)	(25,000)
Net Income	$(20,000)	$(15,000)

Accounts Receivable	Year 1	Year 2
Beginning accounts receivable balance	$0	$10,000
Plus: Increases due to sales on account	50,000	40,000
Minus: Decreases due to receivables collections	(40,000)	(50,000)
Yields: Ending accounts receivable balance	$10,000	$0

Operating Activities Section of Statement of Cash Flows	Year 1	Year 2
Cash collections from customers	$40,000	$50,000
Cash payments for expense	(25,000)	(30,000)
Net cash flow from operating activities	$15,000	$20,000

Accounts Payable	Year 1	Year 2
Beginning accounts payable balance	$0	$5,000
Plus: Increases due to expenses incurred on account	30,000	25,000
Minus: Decreases due to payments to reduce accounts payable	(25,000)	(30,000)
Yields: Ending accounts payable balance	$5,000	$0

Class Discussion

The discussion should focus on how accrual accounting facilitates the matching of revenues with expenses.

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ATC 2-3

Dollar amounts are in thousands.

a.

	2015	2016
Revenues	$2,842,284	$2,912,351
- Expenses	2,678,381	2,723,052
Net income	$ 163,903	$ 189,299
Beg. retained earnings	$ 483,167	$ 475,687
+ Net income	163,903	189,299
- Dividends	171,383	186,505
End. Retained earnings	$ 475,687	$ 478,481

b. **Revenue increased by 2.5%**
($2,912,351 - $2,842,284) ÷ $2,842,284 = 2.5%

Net income increased by 15.5%
($189,299 - $163,903) ÷ $163,903 = 15.5%

c. **2015: $163,903 ÷ $2,842,284 = 5.8%**
2016: $189,299 ÷ $2,912,351 = 6.5%

d. **Both revenues and net income increased in 2016, and net income as a percentage of revenues was also higher in 2016, thus, 2016 appears to have been a better year than 2015.**

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ATC 2-4

Dollar amounts in thousands.

a. and b.

	2015	2016
Cash from operating activities	$ 237,260	$ 282,589
Cash from investing activities	(365,191)	(144,844)
Cash from financing activities	45,499	(99,666)
Net change in cash	(82,432)	38,079
+ Beg. cash balance	93,329	10,897
= End. Cash balance	$ 10,897	$ 48,976

c. **Negative cash flow from investing activities is most likely an indication that the company is growing, which is not a negative situation.**

Note to instructor: The ending cash balances shown above will not match exactly with those on the company's balance sheet due to small adjustments for "exchange rate adjustments." These were omitted to simplify this problem.

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ATC 2-5

The memo provided by students should convey knowledge of the following relationships.

> **The amount of revenue recognized on account was greater than the amount of cash collected from customers. Accordingly, the amount of revenue recognized will be higher than the amount of cash collected thereby making net income higher than net cash flow from operating activities. At the end of the period, there will be a $9,000 balance in the accounts receivable account. This balance represents the amount of cash Corola expects to collect from customers in the next accounting period.**

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ATC 2-6

a.

Income Statement		Balance Sheet	
Service Revenue	$120,000	Assets:	$167,000
Operating Exp.	(40,000)		
Net Income	$ 80,000	Liabilities:	$ 5,000
		Stockholders' Equity:	
		Common Stock	82,000
		Retained Earnings	80,000
		Total Stk Eqty.	162,000
		Total Liab. and Stk. Equity	$167,000

Computations for Income Statement Items:

Revenue: $38,000 + $82,000 = $120,000
Operating Expense: $70,000 – $30,000 = $40,000

Computations for Balance Sheet Items:

Assets: $85,000 + $82,000 = $167,000
Liabilities: $35,000 – $30,000 = $5,000
Retained Earnings: $(32,000) + $82,000 + $30,000 = $80,000

b. Willful deception is an act of fraud and punishable under the law. Good intentions are not sufficient justification for breaking the law. Students should learn to avoid operating under an ends justifies the means philosophy. Suppose the unexpected happens in this case. Glenn fails to obtain the contract and is forced to declare bankruptcy after having manipulated the statements. He would not only stand to lose the friend that he deceived, but also may be convicted of a felony on charges of fraudulent reporting.

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ACT 2-6 (cont.)

c. **The auditing profession has identified three elements that are typically present when fraud occurs. They are: (1) the availability of an opportunity, (2) the existence of some form of pressure leading to an incentive, and (3) the capacity for rationalization. Glenn had the opportunity to record the questionable adjustments because he was the owner and could make whatever adjustments he deemed appropriate. Glenn's existence of pressure is the fact that he needs the financial statements to look good in order to obtain the loan. Because Glenn was confident that the contracts would be approved, he was able to rationalize making the adjustments. All three of the factors of ethical misconduct are present in this case.**

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ATC 2-7

This solution is based on Netflix's 2016 financial report. If the instructor chooses to use a more current report it will be necessary to reconstruct the solution.

Dollar amounts are in thousands.

a. **Netflix's accrual accounts are:**

Current content liabilities (though students will probably not list this account)
Accounts payable
Accrued expenses

b. **Netflix's net earnings for 2016 were $186,678.**

c. **Retained earnings on December 31, 2015 was $941,925.**
Retained earnings on December 31, 2016 was $1,128,603.

d.

Retained earnings December 31, 2015	**$ 941,925**
Plus Net Income	**186,678**
Retained earnings December 31, 2016	**$1,128,603**

Netflix did not pay any dividends in 2016.

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ANSWERS TO QUESTIONS - CHAPTER 2

1. **Accrual accounting attempts to record the effects of accounting events in the period when such events occur, regardless of when cash is received or paid. The goal is to match expenses with the revenues that they produce.**

2. **Recognition is the act of recording an event in the financial statements. When accruals are used, events are recognized before the associated cash is paid or collected.**

3. **If cash is collected in advance for services, the revenue is recognized when the services are rendered.**

4. **The issue of common stock, which is capital acquired from owners, increases business assets (usually cash) and equity (common stock).**

5. **The recognition of revenue on account increases the corresponding revenue account on the income statement, but does not affect the statement of cash flows. The cash flow statement is affected when the account is collected.**

6. **Revenue is recognized under accrual accounting when a revenue-producing event occurs, i.e., when the revenue is *earned*, even if no cash is collected at the time of the transaction.**

7. **The recognition of expenses affects the accounting equation by either decreasing assets or increasing liabilities (payables) and by decreasing stockholders' equity (retained earnings).**

8. **A claims exchange transaction is one where the claims of creditors (liabilities) increase and the claims of stockholders (retained earnings) decrease, or vice versa. The total amount of claims is unchanged.**

9. **Expenses are recognized under accrual accounting at the time the expense is incurred or resources are consumed, regardless of when cash payment is made.**

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10. **Net cash flows from operations on the cash flow statement may be different from net income because of the application of accrual accounting. Revenues and expenses reported on the income statement may be recognized before or after the actual collection or payment of cash that is reported on the cash flow statement.**

11. **Net income increases stockholders' claims on business assets by increasing retained earnings.**

12. **An expense is a decrease in assets or an increase in liabilities that occurs in the process of generating revenue.**

13. **The purpose of the statement of changes in stockholders’ equity is to display the effects of business operations and stock issued to owners and dividends paid to stockholders. It identifies the ways that an entity's equity increased and decreased as a result of its operations and transactions with its stockholders.**

14. **The purpose of the balance sheet is to provide information about an entity's assets, liabilities, and stockholders’ equity and their relationships to each other at a particular point in time. It provides a list of the economic resources that the enterprise has available for its operating activities and the claims to those resources.**

15. **The balance sheet is dated as of a specific date because it shows information about an entity's assets, liabilities, and stockholders’ equity as of that date, not measured over a time period. The statement of changes in stockholders’ equity, the income statement, and the statement of cash flows reflect transactions that occur over a period of time.**
16. **The statement of cash flows explains the change in cash from one accounting period to the next. It is prepared by analyzing the cash account and summarizing where cash came from and how it was used.**

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17. Period costs are costs that are recognized in an accounting period. Examples of period costs include rent expense, utilities expense, and salaries expense.

18. Salary of the tax return preparer could be directly matched with the revenue that it produces.

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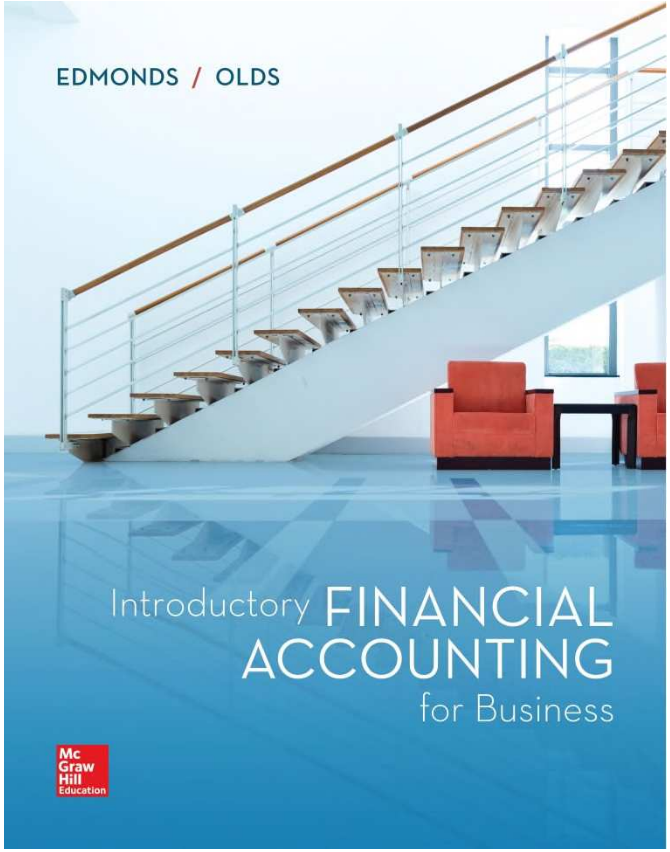

Chapter 2
Accounting for Accruals

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LO 2-1: Use a horizontal financial statements model to show how accounting events affect financial statements.

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Horizontal Financial Statements Model

This model shows a set of financial statements horizontally across a single page of paper. The balance sheet is displayed first (on the left), adjacent to the income statement (in the middle), and then the statement of cash flows (on the far right).

Balance Sheet									Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Land	=	Note Pay.	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income		
	+		=		+		+			−		=			

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Master Builders - Events Year 1

1. Acquired $110,000 cash from the issuance of common stock.

2. Borrowed $400,000 cash.

3. Paid $500,000 cash to purchase land.

4. Received $85,000 cash from earning revenue.

5. Paid $50,000 cash for expenses.

6. Paid $4,000 of cash dividends to the owners.

7. The market value of the land was appraised at $525,000 on December 31, Year 1.

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Horizontal Financial Statements Model

Event 1: Acquired $110,000 cash from the issuance of common stock.

Balance Sheet										Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Land	=	Note Pay.	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		
110,000	+	n/a	=	n/a	+	110,000	+	n/a		n/a	−	n/a	=	n/a	110,000	FA

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Horizontal Financial Statements Model

Event 2: Borrowed $400,000 cash.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Land	=	Note Pay.	+	Common Stock	+	Retained Earnings			Revenue	−	Expenses	=	Net Income		
400,000	+	n/a	=	400,000	+	n/a	+	n/a			n/a	−	n/a	=	n/a	400,000	FA

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Horizontal Financial Statements Model

Event 3: Paid $500,000 cash to purchase land.

Balance Sheet																		
Assets			=	Liab.	+	Stockholders' Equity				Income Statement						Statement of Cash Flows	
Cash	+	Land	=	Note Pay.	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income			
(500,000)	+	500,000	=	n/a	+	n/a	+	n/a		n/a	−	n/a	=	n/a		(500,000)	IA

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Horizontal Financial Statements Model

Event 4: Received $85,000 cash from earning revenue.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Land	=	Note Pay.	+	Common Stock	+	Retained Earnings			Revenue	−	Expenses	=	Net Income		
85,000	+	n/a	=	n/a	+	n/a	+	85,000			85,000	−	n/a	=	85,000	85,000	OA

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Horizontal Financial Statements Model

Event 5: Paid $50,000 cash for expenses.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Land	=	Note Pay.	+	Common Stock	+	Retained Earnings			Revenue	−	Expenses	=	Net Income		
(50,000)	+	n/a	=	n/a	+	n/a	+	(50,000)			n/a	−	50,000	=	(50,000)	(50,000)	OA

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Horizontal Financial Statements Model

Event 6: Paid $4,000 of cash dividends to the owners.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Land	=	Note Pay.	+	Common Stock	+	Retained Earnings			Revenue	−	Expenses	=	Net Income		
(4,000)	+	n/a	=	n/a	+	n/a	+	(4,000)			n/a	−	n/a	=	n/a	(4,000)	FA

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Horizontal Financial Statements Model

Event 7: The market value of the land was appraised at $525,000 on December 31, Year 1.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Land	=	Note Pay.	+	Common Stock	+	Retained Earnings			Revenue	−	Expenses	=	Net Income		
n/a	+	n/a	=	n/a	+	n/a	+	n/a			n/a	−	n/a	=	n/a	n/a	n/a

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Seven Events

Event	Assets			=	Liab.	+	Stockholders' Equity								Cash Flow	
	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income	Cash Flow	
Begin	**0**		**0**		**0**		**0**		**0**	**0**		**0**		**0**	**n/a**	
1.	110,000	+	n/a	=	n/a	+	110,000	+	n/a	n/a	−	n/a	=	n/a	110,000	FA
2.	400,000		n/a		400,000		n/a		n/a	n/a		n/a		n/a	400,000	FA
3.	(500,000)		500,000		n/a		n/a		n/a	n/a		n/a		n/a	(500,000)	IA
4.	85,000		n/a		n/a		n/a		85,000	85,000		n/a		85,000	85,000	OA
5.	(50,000)		n/a		n/a		n/a		(50,000)	n/a		50,000		(50,000)	(50,000)	OA
6.	(4,000)		n/a		n/a		n/a		(4,000)	n/a		n/a		n/a	(4,000)	FA
7.	n/a		n/a		n/a		n/a		n/a	n/a		n/a		n/a	n/a	
End	41,000		500,000		400,000		110,000		31,000	85,000	-	50,000	=	35,000	41,000	NC

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LO 2-2: Show how receivables affect financial statements.

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Cash Basis Versus Accrual Accounting

- The term **accrual** describes a revenue or an expense event that is recognized *before* cash is exchanged.
- **Recognition results in** formally recording an economic item or event in the financial statements.
- **Realization results in** collecting cash, generally from the sale of products or services.

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Event 1

- Cato Consultants was started on January 1, Year 1, when it acquired $5,000 cash by issuing common stock.
- Acquiring cash from the issue of common stock is an **asset source transaction**.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Accounts Rec.	=	Sal. Pay.	+	Common Stock	+	Retained Earnings			Revenue	−	Expenses	=	Net Income		
5,000	+	n/a	=	n/a	+	5,000	+	n/a			n/a	−	n/a	=	n/a	5,000	FA

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Event 2

- During Year 1, Cato Consultants provided $84,000 of consulting services to its clients. Cato has completed the work and sent bills to the clients, but has not yet collected any cash. This type of transaction is frequently described as providing services “on account.”
- Because the revenue recognition causes assets (accounts receivable) to increase, it is classified as an **asset source transaction**.

Balance Sheet										Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Accounts Rec.	=	Sal. Pay.	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		
n/a	+	84,000	=	n/a	+	n/a	+	84,000		84,000	−	n/a	=	84,000	n/a	n/a

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Event 3

- Cato collected $60,000 cash from customers in partial settlement of its accounts receivable.
- The collection of an account receivable is an **asset exchange transaction**.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Accounts Rec.	=	Sal. Pay.	+	Common Stock	+	Retained Earnings			Revenue	−	Expenses	=	Net Income		
60,000	+	(60,000)	=	n/a	+	n/a	+	n/a			n/a	−	n/a	=	n/a	60,000	OA

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Event 4

- Cato paid an instructor a $10,000 cash salary for teaching courses.
- Cash payment for salary expense is an **asset use transaction.**

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity											
Cash	+	Accounts Rec.	=	Sal. Pay.	+	Common Stock	+	Retained Earnings			Revenue	−	Expenses	=	Net Income		
(10,000)	+	n/a	=	n/a	+	n/a	+	(10,000)			n/a	−	10,000	=	(10,000)	(10,000)	OA

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Event 5

- Cato paid $2,000 for advertising costs. The advertisements appeared in Year 1.
- The cash payment for advertising expense is an **asset use transaction**.

Balance Sheet									Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Accounts Rec.	=	Sal. Pay.	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income		
(2,000)	+	n/a	=	n/a	+	n/a	+	(2,000)	n/a	−	2,000	=	(2,000)	(2,000)	OA

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LO 2-3: Show how payables affect financial statements.

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Event 6

- At the end of Year 1, Cato recorded accrued salary expense of $6,000. The salary expense is for courses the instructor taught in Year 1. However, Cato will not pay the instructor cash until Year 2.

- Expenses that are recognized before cash is paid are called **accrued expenses.** The accounting for Event 6 illustrates the effect of recognizing accrued salary expense. The entry required to update the account balances is called an **adjusting entry.**

- Recognizing accrued expense is a **claims exchange transaction.**

Balance Sheet									Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Accounts Rec.	=	Sal. Pay.	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income		
n/a	+	n/a	=	6,000	+	n/a	+	(6,000)	n/a	−	6,000	=	(6,000)	n/a	n/a

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Event 7

- During Year 1, Cato signed contracts for $42,000 of consulting services to be performed in Year 2.
- Revenue is recognized for work actually completed, not work expected to be completed.
- This event does not affect any of the financial statements.

Balance Sheet									Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Accounts Rec.	=	Sal. Pay.	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income		
n/a	+	n/a	=	n/a	+	n/a	+	n/a	n/a	−	n/a	=	n/a	n/a	n/a

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LO 2-4: Prepare financial statements that include accruals.

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Cato Consultants, Transaction Data for Yr. 1

1. Cato Consultants acquired $5,000 cash by issuing common stock.

2. Cato provided $84,000 of consulting services on account.

3. Cato collected $60,000 cash from customers in partial settlement of its accounts receivable.

4. Cato paid $10,000 cash for salary expense.

5. Cato paid $2,000 cash for Year 1 advertising costs.

6. Cato recognized $6,000 of accrued salary expense.

7. Cato signed contracts for $42,000 of consulting services to be performed in Year 2.

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Accounting Equation
Preparing a Balance Sheet

Event	Assets			=	Liab.	+	Stockholders' Equity			Other Account Titles
	Cash	+	Accounts Receivable	=	Salaries Payable	+	Common Stock	+	Retained Earnings	
Begin	**0**		**0**		**0**		**0**		**0**	
1.	5,000						5,000	+		
2.			84,000						84,000	Consulting Revenue
3.	60,000		(60,000)							
4.	(10,000)								(10,000)	Salary Expense
5.	(2,000)		n/a		n/a		n/a		(2,000)	Advertising Expense
6.	n/a		n/a		6,000		n/a		(6,000)	Salary Expense
7.	n/a		n/a		n/a		n/a		n/a	
End	**53,000**		**24,000**		**6,000**		**5,000**		**66,000**	

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Balance Sheet		
As of December 31, Year 1		
Assets		
Cash	$53,000	
Accounts receivable	24,000	
Total assets		$ 77,000
Liabilities		
Salaries payable		$ 6,000
Stockholders equity		
Common stock	$ 5,000	
Retained earnings	66,000	
Total stockholders' equity		71,000
Total liabilities and stockholders' equity		$ 77,000

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Accounting Equation
Preparing an Income Statement

Event	Assets			=	Liab.	+	Stockholders' Equity			Other Account Titles
	Cash	+	Accounts Receivable	=	Salaries Payable	+	Common Stock	+	Retained Earnings	
Begin	**0**		**0**		**0**		**0**		**0**	
1.	5,000						5,000	+		
2.			84,000						84,000	Consulting Revenue
3.	60,000		(60,000)							
4.	(10,000)								(10,000)	Salary Expense
5.	(2,000)		n/a		n/a		n/a		(2,000)	Advertising Expense
6.	n/a		n/a		6,000		n/a		(6,000)	Salary Expense
7.	n/a		n/a		n/a		n/a		n/a	
End	**53,000**		**24,000**		**6,000**		**5,000**		**66,000**	

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CATO CONSULTANTS	
Financial Statements	
Income Statement	
For the Year Ended December 31, Year 1	
Consulting revenue	$84,000
Salary expense	(16,000)
Advertising expense	(2,000)
Net income	$66,000

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Accounting Equation
Preparing a Statement of Changes in Stockholders' Equity

Event	Assets			=	Liab.	+	Stockholders' Equity				
	Cash	+	Accounts Receivable	=	Salaries Payable	+	Common Stock	+	Retained Earnings		Other Account Titles
Begin	0		0		0		0		0		
1.	5,000						5,000	+			
2.			84,000						84,000		Consulting Revenue
3.	60,000		(60,000)								
4.	(10,000)								(10,000)		Salary Expense
5.	(2,000)		n/a		n/a		n/a		(2,000)		Advertising Expense
6.	n/a		n/a		6,000		n/a		(6,000)		Salary Expense
7.	n/a		n/a		n/a		n/a		n/a		
End	53,000		24,000		6,000		5,000		66,000		

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Statement of Changes in Stockholders' Equity
For the Year Ended December 31, Year 1

Beginning common stock	$ 0	
Plus: Common stock issued	5,000	
Ending common stock		$ 5,000
Beginning retained earnings	0	
Plus: Net income	66,000	
Less: Dividends	0	
Ending retained earnings		66,000
Total stockholders' equity		$ 71,000

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Preparing a Statement of Cash Flows

1. Cato Consultants acquired $5,000 cash by issuing common stock.
3. Cato collected $60,000 cash from customers in partial settlement of its accounts receivable.
4. Cato paid $10,000 cash for salary expense.
5. Cato paid $2,000 cash for Year 1 advertising costs.

Event		Assets			=	Liab.	+	Stockholders' Equity		
	Activity Type	Cash	+	Accounts Receivable	=	Salaries Payable	+	Common Stock	+	Retained Earnings
Begin		0		0		0		0		0
1.	FA	5,000						5,000	+	
2.				84,000						84,000
3.	OA	60,000		(60,000)						
4.	OA	(10,000)								(10,000)
5.	OA	(2,000)		n/a		n/a		n/a		(2,000)
6.		n/a		n/a		6,000		n/a		(6,000)
7.		n/a		n/a		n/a		n/a		n/a
End		53,000		24,000		6,000		5,000		66,000

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Statement of Cash Flows For the Year Ended December 31, Year 1		
Cash flows from operating activities		
Cash receipts from customers	$60,000	
Cash payment for salary expense	(10,000)	
Cash payment for advertising expense	(2,000)	
Net cash flows from operating activities		$48,000
Cash flows from investing activities		0
Cash flows from financing activities		
Cash receipt from issuing common stock	5,000	
Net cash flow from financing activities		5,000
Net change in cash		53,000
Plus: Beginning cash balance		0
Ending cash balance		$53,000

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Comparing Cash Flow from Operating Activities with Net Income

The amount of net income measured using accrual accounting differs from the amount of cash flow from operating activities. For Cato Consulting in Year 1, the differences are summarized below. The Cato illustration demonstrates that a company may recognize a revenue or expense without a corresponding cash collection or payment occurring in the same accounting period.

	Accrual Accounting	Cash Flow
Consulting Revenue	$84,000	$60,000
Salary Expense	(16,000)	(10,000)
Advertising Expense	(2,000)	(2,000)
Net income	$66,000	$48,000

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Matching Concept

- Cash basis accounting can distort the measurement of net income because it sometimes fails to properly match revenues with expenses.
- The problem is that cash is not always received or paid in the period when the revenue is earned or when the expense is incurred.
- The objective of accrual accounting is to improve matching of revenues with expenses.

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LO 2-5: Show how notes payable and interest expense affect financial statements.

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Cato's Second Accounting Cycle: Event 1

- Cato paid cash to its employees to settle the $6,000 of salaries payable that was accrued in Year 1.
- This **asset use transaction:** (1) decreases assets (Cash) and (2) decreases liabilities (Salaries Payable).

Balance Sheet										Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity										
Cash	+		=	Sal. Pay.	+	Common Stock	+	Retained Earnings		Revenue	–	Expenses	=	Net Income		
(6,000)	+	n/a	=	(6,000)	+	n/a	+	n/a		n/a	–	n/a	=	n/a	(6,000)	OA

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Cato's Second Accounting Cycle: Event 2

- Cato acquired $3,000 cash by issuing common stock.

- Acquiring cash from the issue of common stock is an **asset source transaction**.

Balance Sheet										Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity										
Cash	+		=	Sal. Pay.	+	Common Stock	+	Retained Earnings		Revenue	–	Expenses	=	Net Income		
3,000	+	n/a	=	n/a	+	3,000	+	n/a		n/a	–	n/a	=	n/a	3,000	FA

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Cato’s Second Accounting Cycle: Event 3

- Cato incurred $4,000 of utility expense on account.
- Recognizing accrued expense is a **claims exchange transaction.**
- The claims of creditors increase and the claims of stockholders decrease. Total claims remain unchanged.

Balance Sheet									Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity									
Cash	+		=	Acct. Pay.	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income		
n/a	+	n/a	=	4,000	+	n/a	+	(4,000)	n/a	−	4,000	=	(4,000)	n/a	n/a

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Cato's Second Accounting Cycle: Event 4

- Cato paid $3,500 cash in partial settlement of its accounts payable.
- This event reduces assets (cash) and liabilities (accounts payable) on the balance sheet.

Balance Sheet										Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity										
Cash	+		=	Acct. Pay.	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		
(3,500)	+	n/a	=	(3,500)	+	n/a	+	n/a		n/a	−	n/a	=	n/a	(3,500)	OA

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Cato's Second Accounting Cycle: Event 5

- On February 1, Year 1, Cato borrowed $5,000 cash from the State Bank. The note carries a 6% interest rate, payable annually.
- Issuing the note is an **asset source transaction**.

Balance Sheet										Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity										
Cash	+		=	Note Pay.	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		
5,000	+	n/a	=	5,000	+	n/a	+	n/a		n/a	−	n/a	=	n/a	5,000	FA

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Cato's Second Accounting Cycle: Event 6

- During Year 1, Cato Consultants provided $89,000 of consulting services on account.
- Because the revenue recognition causes assets (accounts receivable) to increase, it is classified as an **asset source transaction**. On the balance sheet, assets and stockholders' equity increase. Specifically, the increase in revenue increases net income and ultimately retained earnings. The collection of cash will occur in the future. Because cash was not collected or paid, the statement of cash flows is not affected for this event.

Balance Sheet									Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity									
Cash	+	Acct. Rec.	=		+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income		
n/a	+	89,000	=	n/a	+	n/a	+	89,000	89,000	−	n/a	=	89.000	n/a	n/a

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Cato's Second Accounting Cycle: Event 7

- Cato collected $95,000 cash from customers in a partial settlement of its accounts receivable.
- The collection of an account receivable is an **asset exchange transaction**. Cash increases, while another asset, Accounts Receivable, decreases.

Balance Sheet										Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity										
Cash	+	Acct. Rec.	=		+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		
95,000	+	(95,000)	=	n/a	+	n/a	+	n/a		n/a	−	n/a	=	n/a	95,000	OA

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Cato's Second Accounting Cycle: Event 8

- Cato paid $11,000 for salary expense during Year 2.
- Cash payment for salary expense is **asset use transaction**.

Balance Sheet										Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity										
Cash	+		=	Acct. Pay.	+	Common Stock	+	Retained Earnings		Revenue	−	Expenses	=	Net Income		
(11,000)	+	n/a	=	n/a	+	n/a	+	(11,000)		n/a	−	11,000	=	(11,000)	(11,000)	OA

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Cato's Second Accounting Cycle: Event 9

- Cato paid $10,000 cash dividend.
- Dividend payments are classified as financing activities and do not affect the determination of either net income or cash flow from operating activities.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity											
Cash	+		=	Acct. Pay.	+	Common Stock	+	Retained Earnings			Revenue	−	Expenses	=	Net Income		
(10,000)	+	n/a	=	n/a	+	n/a	+	(10,000)			n/a	−	n/a	=	n/a	(10,000)	FA

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Cato's Second Accounting Cycle: Event 10

- On December 31, Year 1, Cato adjusts its books to recognize the amount of interest expense incurred during Year 1.

Principal × Annual interest rate × Time outstanding = Interest expense

\$5,000 × 0.06 × (11/12) = \$275

- The recognition of interest expense is a **claims exchange event**.

Balance Sheet									Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity									
Cash	+		=	Int. Pay.	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income		
n/a	+	n/a	=	275	+	n/a	+	(275)	n/a	−	275	=	(275)	n/a	n/a

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Cato's Second Accounting Cycle: Event 11

- At the end of Year 1, Cato recorded an accrued salary expense of $5,500. The salary expense is for courses the instructor taught in Year 2. However, Cato will not pay the instructor cash until Year 3.
- Recognizing accrued expense is a **claims exchange transaction**.

Balance Sheet									Income Statement					Statement of Cash Flows	
Assets			=	Liab.	+	Stockholders' Equity									
Cash	+		=	Sa. Pay.	+	Common Stock	+	Retained Earnings	Revenue	−	Expenses	=	Net Income		
n/a	+	n/a	=	5,500	+	n/a	+	(5,500)	n/a	−	5,500	=	(5,500)	n/a	n/a

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Year 2 Events, Panel 1

1. Paid $6,000 cash for salaries that were accrued in Year
2. Acquired $3,000 by issuing common stock
3. Incurred $4,000 of utility expense on account.
4. Paid $3,500 cash in partial settlement of accounts payable.
5. On February 1, Year 2, borrowed $5,000 cash from the City Bank.
6. Recognized $89,000 of revenue on account.
7. Collected $95,000 cash from customers in partial settlement of its accounts receivables.
8. Paid $11,000 for salary expense.
9. Paid a $10,000 cash dividend.
10. Adjusted records to recognize the amount of interest expense incurred during Year 2.
11. Recognized $5,500 of accrued salary expense.

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Accounting Equation, Panel 2

Event	Assets			=	Liabilities							+	Stockholders' Equity			
	Cash	+	Accounts Rec.	=	Salaries Pay.	+	Acct. Pay.	+	Int. Pay.	+	Note Pay.	+	Common Stock	+	Retained Earnings	Other Account Titles
Begin	**53,000**	**+**	**24,000**	**=**	**6,000**	**+**	**n/a**	**+**	**n/a**	**+**	**n/a**	**+**	**5,000**		**66,000**	
1.	(6,000)	+	n/a	=	(6,000)	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a	
2.	3,000	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	3,000	+	n/a	
3.	n/a	+	n/a	=	n/a	+	4,000	+	n/a	+	n/a	+	n/a	+	(4,000)	Utility Expense
4.	(3,500)	+	n/a	=	n/a	+	(3,500)	+	n/a	+	n/a	+	n/a	+	n/a	
5.	5,000	+	n/a	=	n/a	+	n/a	+	n/a	+	5,000	+	n/a	+	n/a	
6.	n/a	+	89,000	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	89,000	Revenue
7.	95,000	+	(95,000)	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a	
8.	(11,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(11,000)	Salary Expense
9.	(10,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(10,000)	Dividend
10.	n/a	+	n/a	=	n/a	+	n/a	+	275	+	n/a	+	n/a	+	(275)	Interest Expense
11.	n/a	+	n/a	=	5,500	+	n/a	+	n/a	+	n/a	+	n/a	+	(5,500)	Salary Expense
End	125,500	+	18,000	=	5,500	+	500	+	275	+	5,000	+	8,000	+	124, 225	
	Total assets $143,500	=			Total Liabilities $11,275						+		Stockholders' Equity $132,225			

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Prepare a Balance Sheet

Event	Assets			=	Liabilities							+	Stockholders' Equity			Other Account Titles
	Cash	+	Accounts Rec.	=	Salaries Pay.	+	Acct. Pay.	+	Int. Pay.	+	Note Pay.	+	Common Stock	+	Retained Earnings	
Begin	**53,000**	**+**	**24,000**	**=**	**6,000**	**+**	**n/a**	**+**	**n/a**	**+**	**n/a**	**+**	**5,000**		**66,000**	
1.	(6,000)	+	n/a	=	(6,000)	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a	
2.	3,000	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	3,000	+	n/a	
3.	n/a	+	n/a	=	n/a	+	4,000	+	n/a	+	n/a	+	n/a	+	(4,000)	Utility Expense
4.	(3,500)	+	n/a	=	n/a	+	(3,500)	+	n/a	+	n/a	+	n/a	+	n/a	
5.	5,000	+	n/a	=	n/a	+	n/a	+	n/a	+	5,000	+	n/a	+	n/a	
6.	n/a	+	89,000	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	89,000	Revenue
7.	95,000	+	(95,000)	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a	
8.	(11,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(11,000)	Salary Expense
9.	(10,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(10,000)	Dividend
10.	n/a	+	n/a	=	n/a	+	n/a	+	275	+	n/a	+	n/a	+	(275)	Interest Expense
11.	n/a	+	n/a	=	5,500	+	n/a	+	n/a	+	n/a	+	n/a	+	(5,500)	Salary Expense
End	125,500	+	18,000	=	5,500	+	500	+	275	+	5,000	+	8,000	+	124, 225	
	Total assets $143,500	=			Total Liabilities $11,275						+		Stockholders' Equity $132,225			

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Balance Sheets As of December 31	Year 1	Year 2
Assets		
Cash	$ 53,000	125,500
Accounts receivable	24,000	18,000
Total assets	$ 77,000	143,500
Liabilities		
Salaries Payable	$ 6,000	$ 5,500
Accounts Payable	0	500
Interest Payable	0	275
Note payable	0	5,000
Total Liailities	6,000	11,275
Stockholders' equity		
Common stock	5,000	8,000
Retained earnings	66,000	124,225
Total stockholders' equity	71,000	132,225
Total liabilities and stockholders' equity	$ 77,000	$143,500

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Prepare an Income Statement

Event	Assets			=	Liabilities							+	Stockholders' Equity			Other Account Titles
	Cash	+	Accounts Rec.	=	Salaries Pay.	+	Acct. Pay.	+	Int. Pay.	+	Note Pay.	+	Common Stock	+	Retained Earnings	
Begin	**53,000**	**+**	**24,000**	**=**	**6,000**	**+**	**n/a**	**+**	**n/a**	**+**	**n/a**	**+**	**5,000**		**66,000**	
1.	(6,000)	+	n/a	=	(6,000)	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a	
2.	3,000	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	3,000	+	n/a	
3.	n/a	+	n/a	=	n/a	+	4,000	+	n/a	+	n/a	+	n/a	+	(4,000)	Utility Expense
4.	(3,500)	+	n/a	=	n/a	+	(3,500)	+	n/a	+	n/a	+	n/a	+	n/a	
5.	5,000	+	n/a	=	n/a	+	n/a	+	n/a	+	5,000	+	n/a	+	n/a	
6.	n/a	+	89,000	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	89,000	Revenue
7.	95,000	+	(95,000)	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a	
8.	(11,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(11,000)	Salary Expense
9.	(10,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(10,000)	Dividend
10.	n/a	+	n/a	=	n/a	+	n/a	+	275	+	n/a	+	n/a	+	(275)	Interest Expense
11.	n/a	+	n/a	=	5,500	+	n/a	+	n/a	+	n/a	+	n/a	+	(5,500)	Salary Expense
End	125,500	+	18,000	=	5,500	+	500	+	275	+	5,000	+	8,000	+	124, 225	
	Total assets $143,500	=			Total Liabilities $11,275						+		Stockholders' Equity $132,225			

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Income Statements For the Year Ended December 31		
	Year 1	Year 2
Consulting revenue	$ 84,000	$ 89,000
Salary expense	(16,000)	(16,500)
Advertising expense	(2,000)	0
Utility expense	0	(4,000)
Interest expense	0	(275)
Net income	$66,000	$ 68,225

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Prepare a Statement of Changes in Stk. Equity

Event	Assets			=	Liabilities							+	Stockholders' Equity			
	Cash	+	Accounts Rec.	=	Salaries Pay.	+	Acct. Pay.	+	Int. Pay.	+	Note Pay.	+	Common Stock	+	Retained Earnings	Other Account Titles
Begin	**53,000**	**+**	**24,000**	**=**	**6,000**	**+**	**n/a**	**+**	**n/a**	**+**	**n/a**	**+**	**5,000**		**66,000**	
1.	(6,000)	+	n/a	=	(6,000)	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a	
2.	3,000	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	3,000	+	n/a	
3.	n/a	+	n/a	=	n/a	+	4,000	+	n/a	+	n/a	+	n/a	+	(4,000)	Utility Expense
4.	(3,500)	+	n/a	=	n/a	+	(3,500)	+	n/a	+	n/a	+	n/a	+	n/a	
5.	5,000	+	n/a	=	n/a	+	n/a	+	n/a	+	5,000	+	n/a	+	n/a	
6.	n/a	+	89,000	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	89,000	Revenue
7.	95,000	+	(95,000)	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a	
8.	(11,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(11,000)	Salary Expense
9.	(10,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(10,000)	Dividend
10.	n/a	+	n/a	=	n/a	+	n/a	+	275	+	n/a	+	n/a	+	(275)	Interest Expense
11.	n/a	+	n/a	=	5,500	+	n/a	+	n/a	+	n/a	+	n/a	+	(5,500)	Salary Expense
End	125,500	+	18,000	=	5,500	+	500	+	275	+	5,000	+	8,000	+	124, 225	
	Total assets $143,500	=			Total Liabilities $11,275						+		Stockholders' Equity $132,225			

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Statements of Changes in Stockholders' Equity For the Year Ended December 31		
	Year 1	**Year 2**
Beginning common stock	$ 0	$ 5,000
Plus: Common stock issued	5,000	3,000
Ending common stock	5,000	8,000
Beginning retained earnings	0	66,000
Plus: Net income	66,000	68,225
Less: Dividends	0	(10,000)
Ending retained earnings	66,000	124,225
Total stockholders' equity	$ 71,000	$132,225

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Year 2 Events

1. Paid $6,000 cash for salaries that were accrued in Year
2. Acquired $3,000 by issuing common stock
3. Incurred $4,000 of utility expense on account.
4. Paid $3,500 cash in partial settlement of accounts payable.
5. On February 1, Year 2, borrowed $5,000 cash from the City Bank.
6. Recognized $89,000 of revenue on account.
7. Collected $95,000 cash from customers in partial settlement of its accounts receivables.
8. Paid $11,000 for salary expense.
9. Paid a $10,000 cash dividend.
10. Adjusted records to recognize the amount of interest expense incurred during Year 2.
11. Recognized $5,500 of accrued salary expense.

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Prepare a Statement of Cash Flows

Event		Assets			=	Liabilities							+	Stockholders' Equity		
	Activity Type	Cash	+	Accounts Rec.	=	Salaries Pay.	+	Acct. Pay.	+	Int. Pay.	+	Note Pay.	+	Common Stock	+	Retained Earnings
Begin		**53,000**	+	**24,000**	=	**6,000**	+	**n/a**	+	**n/a**	+	**n/a**	+	**5,000**		**66,000**
1.	OA	(6,000)	+	n/a	=	(6,000)	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a
2.	FA	3,000	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	3,000	+	n/a
3.		n/a	+	n/a	=	n/a	+	4,000	+	n/a	+	n/a	+	n/a	+	(4,000)
4.	OA	(3,500)	+	n/a	=	n/a	+	(3,500)	+	n/a	+	n/a	+	n/a	+	n/a
5.	FA	5,000	+	n/a	=	n/a	+	n/a	+	n/a	+	5,000	+	n/a	+	n/a
6.		n/a	+	89,000	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	89,000
7.	OA	95,000	+	(95,000)	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	n/a
8.	OA	(11,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(11,000)
9.	FA	(10,000)	+	n/a	=	n/a	+	n/a	+	n/a	+	n/a	+	n/a	+	(10,000)
10.		n/a	+	n/a	=	n/a	+	n/a	+	275	+	n/a	+	n/a	+	(275)
11.		n/a	+	n/a	=	5,500	+	n/a	+	n/a	+	n/a	+	n/a	+	(5,500)
End		125,500	+	18,000	=	5,500	+	500	+	275	+	5,000	+	8,000	+	124, 225

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Statements of Cash Flows
For the Year Ended December 31

	Year 1	Year 2
Cash flows from operating activities		
Cash receipts from customers	$ 60,000	$ 95,000
Cash payment for salary expense	(10,000)	(17,000)
Cash payment for advertising	(2,000)	0
Cash payment for utilities	0	(3,500)
Net cash flows from operating activities	48,000	74,500
Cash flows from investing activities	0	0
Cash flows from financing activities		
Cash receipt from issuing common stock	5,000	3,000
Cash receipt from borrowing		5,000
Cash paid for dividends	0	(10,000)
Net cash flow from financing activities	5,000	(2,000)
Net change in cash	53,000	72,500
Plus: Beginning cash balance	0	53,000
Ending cash balance	$ 53,000	$125,500

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Accounting Events for Notes Payable at Maturity Date: Event 1

- On maturity date, January 31, Year 3, Cato adjusts its books to recognize the amount of interest expense incurred during Year 3.
- The amount of interest recognized in Year 3 is calculated as follows:
- **Principal × Annual interest rate × Time outstanding = Interest expense**

$$\$5{,}000 \times 0.06 \times (1/12) = \$25$$

Balance Sheet										Income Statement					Statement of Cash Flows	
Assets			=	Liabilities		+	Stockholders' Equity									
Cash	+		=	Int. Pay.	Note Pay.	+	Com. Stock	+	Retained Earnings	Rev.	−	Exp.	=	Net Income		
n/a	+	n/a	=	25	n/a	+	n/a	+	(25)	n/a	−	25	=	(25)	n/a	n/a

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Accounting Events for Notes Payable at Maturity Date: Event 2

- On maturity date, January 31, Year 3, Cato pays cash to payoff the amount of interest payable.
- The second entry records Cato's cash payment for interest payable.
- This entry is an **asset use transaction** that reduces both the Cash and Interest Payable accounts for the total amount of interest due: $300.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liabilities		+	Stockholders' Equity										
Cash	+		=	Int. Pay.	Note Pay.	+	Com. Stock	+	Retained Earnings		Rev.	–	Exp.	=	Net Income		
(300)	+	n/a	=	(300)	n/a	+	n/a	+	n/a		n/a	–	n/a	=	n/a	(300)	OA

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Accounting Events for Notes Payable at Maturity Date: Event 3

- On maturity date, January 31, Year 3, Cato cash to payoff the notes payable.
- The third entry on January 31, Year 3, reflects repaying the principal.
- This entry is an **asset use transaction**.

Balance Sheet											Income Statement					Statement of Cash Flows	
Assets			=	Liabilities		+	Stockholders' Equity										
Cash	+		=	Int. Pay.	Note Pay.	+	Com. Stock	+	Retained Earnings		Rev.	−	Exp.	=	Net Income		
(5,000)	+	n/a	=	n/a	(5,000)	+	n/a	+	n/a		n/a	−	n/a	=	n/a	(5,000)	FA

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Exhibit 2.5: Summary of How Year 3 Affects Accounts

After these events, there will be a zero balance in the interest and notes payable accounts. Here is a summary of how Year 3 events affected these accounts.

Year 3 Changes in Interest Payable		Year 3 Changes in Notes Payable	
Beginning interest payables balance	275	Beginning notes payables balance	5,000
Plus: Interest accrued during Year 3	25	Plus: Additional borrowing during Year 3	0
Minus: Payments to settle the liability	(300)	Minus: Payments to Settle the Liability	(5,000)
Yields: Ending interest payables balance	0	Yields: ending notes payables balance	0

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LO 2-6: Identify the causes for changes in beginning and ending account balances.

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Causal Factors For Changes in Account Balances

Exhibit 2.6

Year 2 Changes in Accounts Receivable	
Beginning accounts receivable balance	24,000
Plus: Increases due to sales on account	89,000
Minus: Decreases due to receivables collections	(95,000)
Yields: Ending accounts receivable balance	18,000
Year 2 Changes in Accounts Payable	
Beginning accounts payable balance	0
Plus: Increases due to expenses incurred on account	4,000
Minus: Decreases due to payment of accounts payable	(3,500)
Yields: Ending accounts payable	500

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LO 2-7: Identify the primary components of corporate governance.

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Corporate Governance

- **Corporate governance** is the set of relationships between the board of directors, management, shareholders, auditors, and other stakeholders that determines how a company is operated.

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Importance of Ethics

- The accountant's role requires trust and credibility.
- Accounting information is worthless if the accountant is not trustworthy.
- Therefore, the accounting profession requires high ethical standards.

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AICPA Code of Professional Conduct

- Includes articles requiring CPAs to:
  - exercise sensitive professional and moral judgments.
  - act in a way to serve the public interest.
  - perform with the highest sense of integrity.
  - be objective and independent, in fact and appearance.
  - exercise due care.

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Exhibit 2.7: AICPA Code of Professional Conduct

Exhibit 2.9
Principles of Professional Conduct: AICPA Code of Professional Conduct
Responsibilities Principle: In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
The Public Interest Principle: Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
Integrity principle: To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.
Objectivity and Independence Principle: A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.
Due Care Principle: A member should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professionally responsibility to the best of the member’s ability.
Scope and Nature of Services Principle: A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

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Sarbanes–Oxley (SOX) Act

- Prompted by the audit failures of Enron, WorldCom, and others
- Key provisions:
  - Created the Public Company Accounting Oversight Board (PCAOB)
  - Requires management to certify financial statements
  - Imposes harsh penalties on management for violations

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The Fraud Triangle

- **The Fraud Triangle** is a shape with three corners that represent the **elements** present when a fraud occurs, which are:
    1. The availability of an **opportunity**;
    2. Some form of **pressure** leading to an incentive to commit fraud; and
    3. The capacity for **rationalization** that the fraud will "right some type of wrong."

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End of Chapter 2

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