

E3-1

a. It must add value for the customers, possibly by reducing their transactions' costs through providing a convenient location (such as a neighborhood grocery store) or information that helps customers make a better decision (such as a jewelry store).

b. Cash goes down by \$500,000 and inventory goes up by \$500,000. Total assets, total liabilities and equities remain the same.

c. Inventory 500,000
Cash 500,000

d.

	Inventory	
12/31/04 100 @ \$1,000 each	100,000	
Purchases 500 @ \$1,000 each	500,000	
1/1/04 600 @ \$1,000 each	600,000	

e.

	Inventory		
12/31/04 100 @ \$1,000 each	100,000		
Purchases 500 @ \$1,000 each	500,000	400,000	400 @ \$1,000 each
1/1/05 600 @ \$1,000 each	600,000		
Bal. 1/1/05 @ \$1,000 each	200,000		

f. Four hundred items were sold, and the cost of those items was \$400,000. Five hundred items were purchased at a total cost of \$500,000. The income statement contains an expense for the cost of goods sold; therefore, \$400,000 appears on the income statement.

E3-2

	Cash	
BB	-	
a	60.0	
		5.0 b
		49.0 e
d1	73.5	
	79.5	

	Inventory	
BB	-	
c	49.0	
		49.0 d2
	-	

	Land	
BB	-	
b	5.0	
		5.0

	Common Stock	
		- BB
		60.0 a
		60.0

	Retained Earnings	
		- BB
		24.5 c
		24.5

	Sales	
		73.5 d1 d2
c	73.5	
		-

	Cost of goods sold	
	49.0	
		49.0 c
		-

RetailBiz, Inc.
Balance Sheet
As of December 31, 2005

Current asset		Liabilities	\$ -
Cash	\$79.5		
Noncurrent asset		Shareholders' equity	
Land	5.0	Common stock	\$60.0
		Retained earnings	<u>24.5</u>
Total assets	<u>\$84.5</u>	Total Liab. and SE	<u>\$84.5</u>

RetailBiz, Inc.
Income Statement
For the year ended December 31, 2005

Sales	\$73.5
Cost of goods sold	<u>(49.0)</u>
Net income	<u>\$24.5</u>

E3-3

<table style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2" style="text-align: center; border-bottom: 1px solid black;">Cash</th></tr> <tr><td style="width: 50%;">BB</td><td style="width: 50%; text-align: right;">52,000</td></tr> <tr><td>a2</td><td style="text-align: right;">73,500</td></tr> <tr><td></td><td style="text-align: right;">49,000</td></tr> <tr><td></td><td style="text-align: right;">4,000</td></tr> <tr><td></td><td style="text-align: right;">11,000</td></tr> <tr><td>EB</td><td style="text-align: right;"><u>61,500</u></td></tr> </table>	Cash		BB	52,000	a2	73,500		49,000		4,000		11,000	EB	<u>61,500</u>	<table style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2" style="text-align: center; border-bottom: 1px solid black;">Inventory</th></tr> <tr><td>BB</td><td style="text-align: right;">0</td></tr> <tr><td>a1</td><td style="text-align: right;">49,000</td></tr> <tr><td></td><td style="text-align: right;">49,000</td></tr> <tr><td>EB</td><td style="text-align: right;"><u>0</u></td></tr> </table>	Inventory		BB	0	a1	49,000		49,000	EB	<u>0</u>	<table style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2" style="text-align: center; border-bottom: 1px solid black;">Prepaid Rent</th></tr> <tr><td>BB</td><td style="text-align: right;">3,000</td></tr> <tr><td>b</td><td style="text-align: right;">4,000</td></tr> <tr><td></td><td style="text-align: right;">6,000</td></tr> <tr><td>EB</td><td style="text-align: right;"><u>1,000</u></td></tr> </table>	Prepaid Rent		BB	3,000	b	4,000		6,000	EB	<u>1,000</u>	<table style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2" style="text-align: center; border-bottom: 1px solid black;">Wages Payable</th></tr> <tr><td></td><td style="text-align: right;">0</td></tr> <tr><td></td><td style="text-align: right;">1,000</td></tr> <tr><td>EB</td><td style="text-align: right;"><u>1,000</u></td></tr> </table>	Wages Payable			0		1,000	EB	<u>1,000</u>	<table style="width: 100%; border-collapse: collapse;"> <tr><th colspan="2" style="text-align: center; border-bottom: 1px solid black;">Interest Payable</th></tr> <tr><td></td><td style="text-align: right;">0</td></tr> <tr><td></td><td style="text-align: right;">4,000</td></tr> <tr><td>EB</td><td style="text-align: right;"><u>4,000</u></td></tr> </table>	Interest Payable			0		4,000	EB	<u>4,000</u>
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		40,000		EB
Income Summary				
C2	49,000	73,500	C1	
C3	6,000			
C4	12,000			
C5	4,000			
C6	2,500			
	0			

		Sales		
C1	73,500	73,500	a1	a3
		0		

		Cost of goods sold		
		49,000		C2
		0		

		Rent Expense		
A3	6,000	6,000	C3	
		0		

		Wages Expense		
d	11,000			
A1	1,000	12,000	C4	
		0		

		Interest Expense		
A2	4,000			
		4,000	C5	
		0		

Calculations:

Rent expense: \$500 per month x 12 months

Interest expense: 10% per year x 1 year x \$40,000 = \$4,000

LDH, Inc.

Balance Sheet

As of December 31, 2005

(Amounts in thousands)

Current assets		Current liabilities	
Cash	\$ 61.5	Wages payable	\$ 1.0
Prepaid rent	<u>1.0</u>	Interest payable	<u>4.0</u>
Total current assets	\$ <u>62.5</u>	Total current liabilities	<u>\$ 5.0</u>
		Note payable	\$ 40.0
Noncurrent asset		Shareholders' equity	
Land	\$ 5.0	Common stock	\$ 20.0
		Retained earnings	<u>2.5</u>
Total assets	\$ <u>67.5</u>	Total shareholders' equity	<u>\$ 22.5</u>
		Total Liab. and SE	<u>\$ 67.5</u>

LDH, Inc.
Income Statement
For the year ended December 31, 2005
(amounts in thousands)

Sales	\$ 73.5
Cost of goods sold	<u>(49.0)</u>
Gross margin	\$ 24.5
Wages expense	(12.0)
Rent expense	(6.0)
Interest expense	<u>(4.0)</u>
Net income	<u>\$ 2.5</u>

E3-4

Because dividends are a transaction with owners, they are not listed on the income statement. Therefore, LDH's income statement would not change with the payment of the dividend.

LDH's balance sheet, however, would change. *Cash* would decrease by \$2,000 and *Retained earnings* would decrease by \$2,000.

E3-5

We need to determine:

When the earnings process is substantially complete;

When an exchange has taken place; and,

Whether collection is reasonably certain.

These are vague terms, and many answers are allowable at this stage. In particular, the students do not yet know the convention that bad debts are an expense, and they have not seen the allowance method.

One approach would be to not recognize any revenue until the project is totally completed in the year 2007. The costs incurred up to that date would be a type of inventory—say, *Work in process*. This approach would recognize no revenue in 2005 and 2006.

Another approach is to view the progress on the project as substantial completion and an exchange. We could recognize revenue over time in proportion to the costs incurred. Because 10 percent is expected to be completed the first year, we could take 10 percent of \$2.2 million, or \$220 thousand, as revenue in 2005. In 2006, the project progresses from 10 percent done to 40% done. Therefore, 30 percent of the work is done in 2006, and we could take 30 percent of \$2.2 million, or \$660 thousand in 2006. If we took this approach to revenue recognition, we should record matching bad debts expense of 5 percent of the revenue recognized in any period.

No doubt many students will subtract the expected bad debts from revenues. That is, they will view expected revenues as 95% of \$2.2 million, or \$2.0 million. They will argue that 10% of \$2.0 million, or \$200 thousand should be recognized in the first year, and 30% of \$2.0 million should be recognized in 2002.

At this point, there is nothing wrong with this answer. It could serve as a springboard for a discussion of both percentage of completion and the conventional treatment of bad debts as an expense.

E3-6

a. Advertising expenditures are an investment that firms expect will increase revenues in the future.

b. Because the expenditures generate a future benefit, are the result of a past transaction (the purchase of the campaign), and are controlled by Lizant, they create an asset. Because the benefits are equally spread between 2003 and 2004, it is reasonable to put one-half the cost, or \$750 thousand, on the balance sheet as an asset. Matching logic implies the other half should be an expense in 2003.

c. No asset should be on Lizant's balance sheet, because no future benefits exist at the end of 2003.

E3-7

a. It is the same as the balance as of the close of business on March 1, 1997. This is given on the balance sheet for that day: \$25,279 thousand.

b. From the Feb. 28, 1998 balance sheet: \$53,051 thousand.

c. Purchases of inventory make the inventory account increase. The cost of goods sold make the inventory account decrease.

d. Coldwater Creek's cost of goods sold was \$120,126 thousand. It appears on the income statement because it is the expense that has been matched against the net sales of \$246,697.

e. \$147,898 as calculated below:

		Inventory	
3/2/97	Beginning Balance	25,279	
	<i>Plug</i> Purchases	147,898	
			120,126 Cost Of Goods Sold From Income Statement
2/28/98		<u>173,177</u>	<u>120,126</u>
		53,051	