

Haystack Bookstore*

For several years, Arthur King dreamed of owning his own business. One afternoon, he noticed a newspaper ad for the sale of a bookstore in Cannon Beach, Oregon:

Business for Sale - \$125,000

Small bookstore in popular summer vacation resort. Possible owner financing. Contact M. Becker, Cannon Beach, Oregon.

The ad provided a telephone number, so King called Mary Becker and arranged a meeting for the following week.

When he arrived in Cannon Beach, King discovered a small store on a busy street in the heart of town. The building that housed the shop was an attractive older structure that had been remodeled and was in good repair. Inside, the fixtures were clean and well maintained, and the shelves were stocked with best-sellers, travel guides, cookbooks, "how-to" books, and the usual bookstore merchandise.

Mary Becker had owned and operated the Haystack Bookstore for over 20 years. She showed King her accounting records disclosing the cost of inventories and the earnings of the bookstore for the past 5 years. She also indicated that Cannon Beach was growing more popular as a summer resort and as a year-round residence.

King wanted to purchase the business but explained that he could only afford to pay \$45,000 in cash. Becker was eager to sell, so she put King in touch with an individual who was willing to lend him the remaining \$80,000. The loan would be secured by the land and building, bear a 10% interest rate, and require eight annual payments of \$10,000 plus accrued interest. After some discussion, King agreed to these terms and signed a purchase agreement with Becker and a loan agreement with the lender. No cash was exchanged at this stage.

Organizing the new business

King immediately began organizing his business. He was able to contribute \$60,000 in cash to the business after depleting his personal savings and cashing in an insurance policy he owned. On

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March 31, settlement papers were signed and the title was transferred from Becker to King. King received the proceeds from the loan (\$80,000) and paid \$130,000 -- the \$125,000 acquisition price plus \$5,000 for closing costs related to the purchase of the land and building.¹ King decided to allocate the \$125,000 purchase price as follows: \$20,000 for the land, \$80,000 for the building, \$8,500 for fixtures and equipment, and \$16,500 for inventory. He based this allocation on a fair market appraisal value of the land and building (not on often-unreliable county tax records) and the historical cost of the merchandise in inventory. However, he was unsure how the \$5,000 of closing costs should be treated.

On the final day of March, King was busy preparing his store for opening:

- a. He purchased a fire insurance policy covering the building and its contents and paid the \$600 annual premium in advance.
- b. Additional shelving and fixtures were purchased for \$1,300 cash.
- c. A shipment of books arrived accompanied by an invoice² for \$2,800.

Opening for business

On April 1, King opened his store and greeted his first customers. Summary data for the remainder of the year include:

- d. Cash sales for the *9-month* period ending December 31 totaled \$62,300. All sales for the nine months were collected in cash except for one sale to a large local resort in late December. This customer special ordered \$4,000 of books to be given out at the resort's New Year's-eve gala. The books arrived in late December and were delivered to the customer who promised to pay in early January. Thus, the \$4,000 amount is not included in the above cash sales total.
- e. Between April 1 and December 31, Haystack Bookstore took delivery of inventory costing \$43,900. This merchandise was purchased on account.³
- f. King paid \$42,100 in cash to suppliers for the merchandise purchased in c and e.
- g. The cost of telephone service, electricity, and other utilities came to \$1,900 during the April-December period. These costs were paid in cash.
- h. King paid \$2,800 to part-time employees during the busy summer season.

¹ Closing costs include items such as escrow fees, attorney's fees and title insurance.

² An invoice is a "bill" -- a statement of an amount due to a creditor.

³ Purchasing "on account" means that supplier gives the bookstore time to pay for the purchases.

- i. King paid himself a “salary” of \$9,000.
- j. The historical cost of inventory on hand at December 31 was \$19,600.
- k. King determined that the building had a useful life of 20 years and that the fixtures and equipment should be depreciated over 5 years. Of these useful lives, nine months had elapsed.

Questions:

1. Prepare a statement of financial position (also called a “balance sheet”) for the Haystack Bookstore as of the end of the day March 31.
2. Prepare a balance sheet as of December 31.
3. Prepare an income statement for the *9 months* ended December 31. Did Haystack Bookstore earn a profit?