

## Lookout Inn\*

In February 2002, John and Sandra Darby purchased the Lookout Inn near Waterville, New Hampshire. Located on the eastern slope of Lookout Mountain, the inn had been in operation since 1924 when it was converted from a nineteenth-century farmhouse. Waterville had always been a popular summer and autumn vacation area. However, the growing popularity of Nordic skiing has made the area a busy winter resort as well.

The inn offered nine guestrooms on the second and third floors, including the bridal suite, which featured a fireplace and a private bath. The main floor had two sitting rooms, one with a large fireplace, a dining room, kitchen, and a parlor that was used as an office. The price of a room included breakfast, which was served “family style” each morning in the dining room. The inn did not serve lunch or dinner, and breakfast was available only to overnight guests. The “bed and breakfast” format was popular among visitors from eastern metropolitan areas such as Boston and New York, and the Darbys soon discovered that many guests returned regularly.

The Darbys had no formal business training or experience. However, Mr. Darby was an experienced carpenter and was able to handle most of the repairs and maintenance himself. The Darbys worked full time operating the inn. In addition, they hired a part-time employee to handle cleaning and miscellaneous chores around the inn. Overall, they were pleased with the success of their business in 2002 and felt that they had learned a great deal about running the inn during their first year.

One morning, Mr. Darby read an article in the business section of the local newspaper that stated that, due to the recession and cool summer weather, 2002 had been a bad year for tourism throughout most of New England. The article noted that several businesses had declared bankruptcy and that many others had been forced to renegotiate loans and take other measures hoping that 2003 would be a better year. John was concerned about this news and decided to visit his accountant.

Jane Martin, a local C.P.A., had been retained by the Darbys to prepare their tax return for 2002. Nevertheless, she was surprised to see John Darby enter her office. Darby immediately explained: “This article has me a bit unsettled. You see, Sandra and I plan to close the inn for two weeks in April, when business is slow, and take a trip to Florida. Now I’m not so sure that we can afford the vacation.”

---

\* This is a revised version of a case by the same name published in Financial Accounting: A Casebook by Glenn Pfeiffer and Robert Bowen. Revised by Robert Bowen, September 2008.

“It sounds as if you could use a set of financial statements,” Martin said. “You know, a profit and loss statement and a balance sheet. They will tell you how well your business did last year and where you stand at year end.”

Darby interjected: “But isn't a profit and loss statement just the same as our tax statement?”

“Not exactly,” replied Martin. “The objectives of the tax return and profit and loss statement are somewhat different. I think it will be easier to explain after I prepare your statements. I'll stop by the inn tomorrow to get the information I need.”

The only records that the Darbys kept for their business were a checkbook register, which included detailed explanations of all checks drawn, and a file of all invoices received. Mrs. Darby explained to Jane Martin that she was sure that the inn earned a profit in 2002 because the cash balance in the checking account had increased by \$20,000. Martin gathered the information she needed and returned to her office to prepare the financial statements.

Upon arriving at her office, the first thing Martin did was prepare a balance sheet as of February 28, 2002, when the Darbys took over the Lookout Inn (see Exhibit 1). She noted that they had invested \$36,400 of their own capital and had borrowed the remaining amount to finance the business. Next, she prepared a summary of cash deposits and withdrawals based on the Darbys' checkbook (see Exhibit 2). Once she had completed these statements, Martin began to piece together the information she needed to prepare an income statement for 2002.

- a. The Darbys did not accept credit cards or other forms of credit. Also, when they began operating the inn, they instituted a policy of requiring a \$50 deposit for advance reservations. By December 31, 2002, they had collected deposits totaling \$3,900 for reservations in January and February of the following year. These advance payments had been deposited in the Darbys' checking account and were included in the \$59,400 total collected from customers.
- b. Martin determined that, out of the \$10,080 paid toward the Darbys' mortgage, \$9,780 was interest and the remaining \$300 reduced the principal amount owed.
- c. The \$600 paid for insurance provided fire and casualty coverage for the period from March 1, 2002 through February 28, 2003.
- d. The Darbys purchased all of their food and supplies on account.<sup>1</sup> At year-end, they owed a total of \$1,750 to various suppliers. In addition, they estimated that year-end inventories of food and supplies totaled \$550.

---

<sup>1</sup> In other words, the Darbys purchased food and supplies from vendors who extend credit that allowed them to buy now and pay later. The amount the Darbys owed these suppliers at the beginning of the year is shown as ‘accounts payable’ in the balance sheet (Exhibit 1).

- e. Employee wages, utilities, and advertising expenses had been paid in full by year-end.
- f. Mr. Darby estimated that the firewood remaining in the woodpile at December 31, 2002 had cost \$490. Firewood was not part of Food & Supplies Inventories.
- g. Martin determined that depreciation of the building, furnishings, and equipment totaled \$7,680 during the 10-month period ending December 31.

Martin had just about completed the financial statements for the Lookout Inn when she received a phone call from Mrs. Darby. Mrs. Darby explained that she had just received a tax statement from the Town of Waterville. According to the statement, the Darbys will owe property taxes totaling \$1,140 for the 12-month period ending February 28, 2003.

**Questions:**

1. Based on the information provided, prepare:
  - a) A statement of financial position as of December 31, 2002,
  - b) An income statement for the 10-month period from March 1, 2002 through December 31, 2002, and
  - c) A statement of cash flows for the 10-month period from March 1, 2002 through December 31, 2002. (Hint: Examine exhibit 2, Summary of Cash Deposits and Withdrawals, and classify each line item as a cash flow from *operations*, *investing* or *financing*. Then prepare a cash flow statement.)
2. Did the Lookout Inn have a “good” year or a “bad” year? Explain.
3. Explain why the Darbys' income tax return likely differs from the income statement you prepared.

**Exhibit 1**  
Lookout Inn  
Statement of Financial Position  
February 28, 2002

Assets

Current assets	
Cash	\$1,600
Food and supplies	<u>800</u>
Total current assets	2,400
Land	22,000
Building	86,000
Furnishings and equipment	<u>24,600</u>
Total assets	<u>\$135,000</u>

Liabilities and Owners' Equity

Current liabilities	
Accounts payable	<u>\$ 600</u>
Total current liabilities	600
Mortgage payable	<u>98,000</u>
Total liabilities	98,600
Owners' equity	<u>36,400</u>
Total liabilities and owners' equity	<u>\$135,000</u>

**Exhibit 2**  
Lookout Inn  
Summary of Cash Deposits and Withdrawals  
March 1, 2002 – December 31, 2002

Deposits

Receipts collected from customers	<u>\$59,400</u>
Total	<u>\$59,400</u>

Checks drawn

Mortgage payments	\$10,080
Insurance	600
Food and supplies	8,100
Wages	8,400
Utilities	1,650
Advertising	1,200
Firewood	780
Withdrawals by owners	<u>8,590</u>
Total	<u>\$39,400</u>